



"Bezeq" The Israel Telecommunication Corp. Limited

Annual Report for 2006*

Chapter A – Description of Company Operations

**Chapter B – Directors' Report on the State of the Company's
Affairs**

Chapter C – Financial Statements

Chapter D – Additional Details About the Corporation

The information contained in this annual report constitutes a translation of the annual report published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only.

* The annual report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970



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Chapter B – Directors' Report on the State of the Company's Affairs

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Chapter A - Description of Company Operations

In this report, which contains a description of the Group's business operations as at December 31, 2006, the Group included forward-looking information, as defined in the Securities Law 5728-1968 (hereinafter: the "**Securities Law**") with respect to both itself and the market. Such information includes forecasts, targets, appraisals and assessments which apply to future events or matters the realization of which is not certain and is not under the Group's control. Forward-looking information in this report will usually be identified specifically, or by employing statements such as "the Company expects", "the Company assesses", "it is the Company's intention", and similar statements.

Forward-looking information is not a proven fact and is based only on the Group's subjective assessment, based, inter alia, on a general analysis of the information available at the time of drafting of this report, including public announcements, studies and surveys, and they contain no undertakings as to the correctness or completeness of the information contained therein, and the Group does not independently check the correctness thereof.

In addition, the realization and/or otherwise of the forward-looking information will be affected by factors that cannot be assessed in advance, and which are not within the control of the Group, including the risk factors that are characteristic of its operations as set out in this report, and developments in the general environment, and external factors and the regulation that affects the Group's operations, as set out in this report.

1. Description of General Development of Group Operations

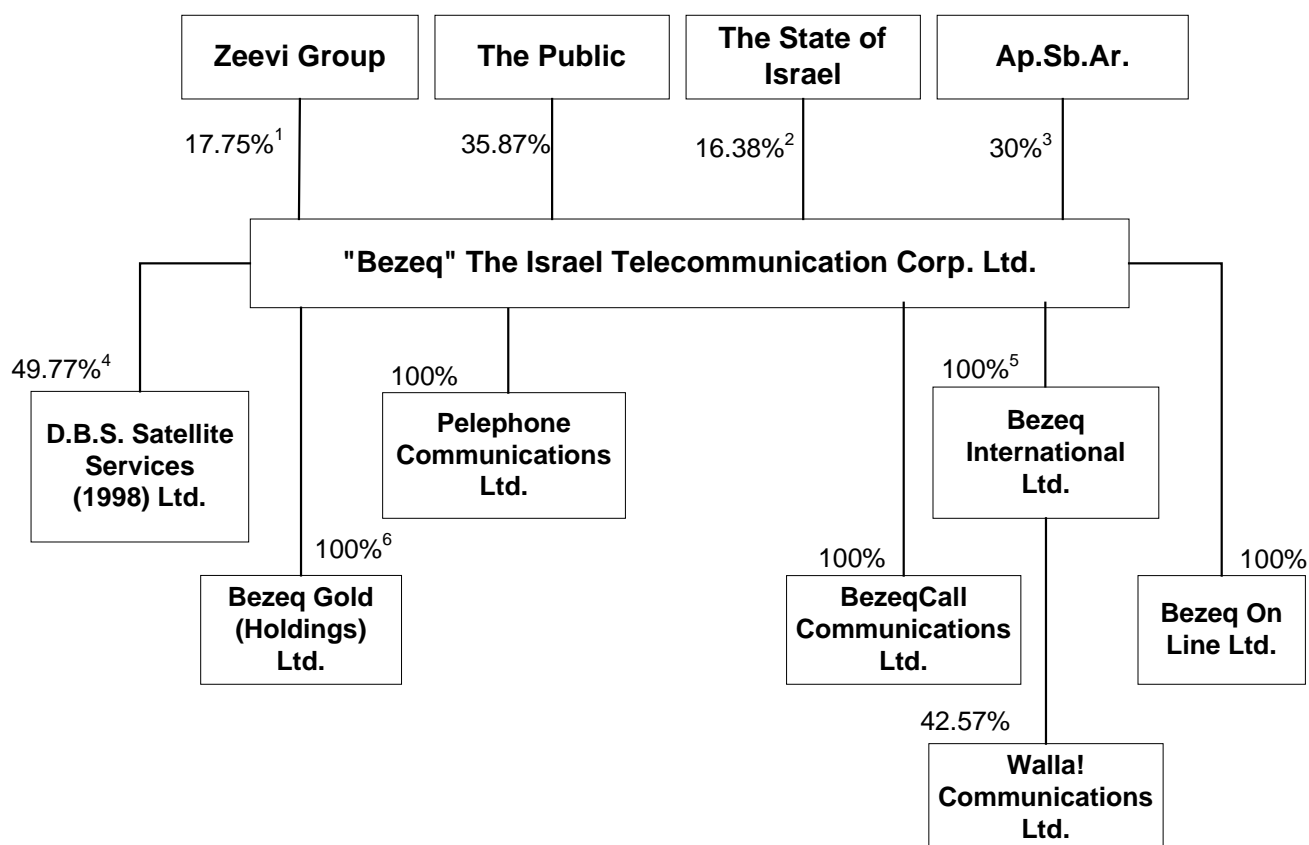
"Bezeq" – The Israel Telecommunications Corp. Limited ("the Company" or "Bezeq") along with the subsidiaries that it owns in whole or in part, whose financial statements are consolidated with the Company's, shall be jointly referred to in this periodic report as "the Group" or "the Bezeq Group".

In its financial statements for 2006, the Company and its subsidiaries are reporting for the first time in accordance with international financial reporting standards (IFRS). The date for transition to IFRS was prescribed for January 1, 2005, and as a result, the Company has presented its financial statements for 2005 once again, these having been reported in the past in accordance with the accounting rules employed in Israel. In this regard, see Note 33 to the Company's financial statements for the period ended December 31, 2006, which are included in this periodic report.

1.1 Group Activity and Description of its Business Development

- 1.1.1 As of the date of this periodic report, The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international communications services, transmission to the public of satellite multi-channel television broadcasts, internet access services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, satellite services, transmission to the public of television and radio broadcasts, provision of services and maintenance of equipment on customer premises (network end point services).
- 1.1.2 Both in the global markets and in Israel, the pace of development in the telecommunications sector is rapid. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.
- 1.1.3 The Company was founded as a government company in 1980 and has been privatized over a period of years. The Company is a public company, the shares in which are traded on the Tel Aviv Stock Exchange.
- 1.1.4 As of October 11, 2005, the holder of control of the Company is Ap. Sab. Ar. Holdings Ltd. ("**Ap. Sab. Ar.**") which holds 30% of the shares in the Company, as well as an option to purchase up to 10.66% of the shares in the Company that are held by the State.

The diagram below outlines the holdings in the Company and the holdings of the Company in its subsidiaries and principal affiliated companies, as of the date of the periodic report:



Note: The Company's holdings are correct as at the date of publication of this periodic report. As noted in section 2.9.6 below, the Company issued 78,151,368 options to employees (with the exception of members of senior management), convertible into 78,151,368 shares of the Company, as part of an employee option scheme⁸. The rate of holdings of the Company under full dilution, presuming exercise of all of the options under the above scheme, is as follows:

Ap. Sab. Ar - 29.13%
 The State of Israel - 15.91%
 The Zeevi Group - 17.23%
 The public - 37.73%

1.1.5 Mergers and Acquisitions

-
- ¹ Of this, 17.63% are held by Zeevi Communications Holdings Ltd., to which a receiver has been appointed, with authority to exercise the rights flowing from the shares in accordance with the ruling and approval of the Court.
 - ² For the option granted to Ap. Sab. Ar. to purchase up to approximately 10.66% of the State's shares, see section 1.3 below; for employee options, see section 2.9 below.
 - ³ The shareholders in Ap. Sab. Ar. are: 1. SCG Israel Ventures LLC (capital 45%, voting 40.5%) which is controlled by private companies controlled by Haim Saban. 2. Purple Green Project and Investment Co. Ltd. together with Yellow Green Financing and Investment Ltd. (jointly: capital 45%, voting 40.5%), indirectly wholly owned (100%) by corporations in the Apax Europe VI Fund, managed by Apax Europe Managers Ltd. 3. Arkin Communications Ltd. (capital 10%, voting 19%), which is wholly owned (100%) by Moshe Arkin.
 - ⁴ As of the date of publication, the Company has an option to increase its holdings in DBS to approximately 58.36% reflecting the proportional percentage of its investments, see section 1.1.5 (A).
 - ⁵ The operations of the Goldnet Communications Services partnership have been transferred to Bezeq International Ltd. BezeqCall Communications Ltd. has also been merged into Bezeq International Ltd. See sections 1.1.5 and 1.1.6 below.
 - ⁶ An inactive company which holds debentures (series 5) of the Company (see section 2.13.7 and 2.17.1 below).
 - ⁷ 33.66% under full dilution.
 - ⁸ Of this sum, approximately 59,574 options will be issued to two directors from among the employees subject to and following the approval of the general meeting of the shareholders of the Company, which is expected to be held on April 15, 2007.

A. DBS Satellite Services (1998) Ltd. (hereinafter: "DBS")

On January 2, 2005, the Antitrust Commissioner conditionally approved the merger between the Company and DBS (increase of the Company's holdings in DBS to more than 50%). The merger did not take place within a year of the date of approval of the merger, and required a new consent. On August 2, 2006, the Company and DBS submitted new merger notices to the Antitrust Commissioner (the "**Commissioner**") regarding the exercise of options for DBS's shares by the Company, which are expected to increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Commission gave notice of the Antitrust Commissioner's objection to the merger and on February 18, 2007, the grounds for such objection were given. The Company intends to file an appeal against this decision.

In this regard, see also Note 32 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

B. Merger of Bezeq International Ltd. and BezeqCall Communications Ltd.

At the end of July 2006, proceedings were initiated for merger of the operations of the subsidiary BezeqCall Communications Ltd. (network end point operations) and the subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for business), so that the operations of BezeqCall would transfer to Bezeq International. On October 5, 2006 the merger was approved by the Antitrust Commissioner. On December 31, 2006 the Ministry of Communications gave its approval for assign of BezeqCall's network end point license to Bezeq International, and the merger became final on February 11, 2007.

C. Acquisition of Tadiran-Telecom

On October 15, 2006, BezeqCall Communications (before the merger with Bezeq International) signed an agreement to acquire all the operations of Tadiran-Telecom – Israel Communication Services, a limited partnership, in consideration of NIS 93 million (subject to certain adjustments depending on the date of closing the transaction). The closing was subject to the completion of a due diligence process and to the receipt of approvals, including from the Antitrust Commissioner. On March 27, 2007, the Company was informed that the Antitrust Commissioner did not approve of the transaction. Bezeq International Ltd. and Tadiran Telecom are considering their steps in this regard.

1.1.6 **Disposals**

Satellite Communications Operations

The Company terminated contacts with potential buyers for its satellite communication operations (Inmarsat and Bezeq Sat), and is assessing its further activity in this field.

Walla! Communications Ltd.

Further to immediate reports of the Company on April 10, 2006 and June 22, 2006, concerning examination of the holdings in Walla! Communications Ltd. through the subsidiary Bezeq International Ltd., the Company announced, in an immediate report on July 19, 2006, that it has terminated the contacts it had made on this subject.

Goldnet Communication Services ("Goldnet")

On April 30, 2006, an agreement was signed between the Company, Malam Systems Ltd. and Goldnet, a limited partnership, of the first part, and the subsidiary Bezeq International of the other part, concerning acquisition of all the operations of Goldnet by Bezeq International in consideration of NIS 6.8 million, to be divided between the Company (NIS 5.1 million) and Malam Systems (NIS 1.7 million). The agreement has been concluded and Goldnet's operations have been transferred to Bezeq International. In this regard, see also section 4.9.2 below.

1.2 **Areas of Operation**

The Group has four principal areas of operation. These four areas of activity are reported as business segments in the Company's consolidated financial statements (see also Note 28 to the Company's financial statements for the year ended December 31, 2006, included in this periodic report):

1.2.1 Fixed-line domestic communications

This segment primarily includes telephony services, internet access services, transmission services and data communications. This activity is performed by the Company.

1.2.2 Cellular

Cellular mobile radio-telephone services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems. This activity is performed by Pelephone Communications Ltd. (hereinafter: "**Pelephone**").

1.2.3 International communications and internet services

International communications services as well as internet access services (ISP). This activity is performed by Bezeq International Ltd. (hereinafter: "**Bezeq International**"). Bezeq International also holds 42.57% (33.66% fully diluted) of Walla! Communications Ltd., an Israeli company whose shares are registered for trading on the Tel Aviv Stock Exchange, and which deals in the provision of services in the field of internet, and in the activation of internet portals (see section 4.14 below).

1.2.4 Multi-channel television

Multi-channel digital television broadcasts to subscribers over satellite (DBS) and provision of value-added services to subscribers. This activity is performed by DBS Satellite Services (1998) Ltd. (hereinafter: "**DBS**").

Note that in the past, the Company, in its financial statements, reported an area of operations entitled "Others", which included the operations of BezeqCall Communications Ltd., which dealt in network end point services, the Goldnet Communications Services Partnership, which dealt in content services, and Bezeq On-Line, which deals in call center services. Due to the merger of the operations of BezeqCall Communications (see section 1.1.5 above) and Goldnet (see section 1.1.6 above) into Bezeq International, and due to the fact that Bezeq On-Line's operations are not substantial at the Group level, the Company will not include reference to the "others" sector in its financial statements for 2007. The 2006 report did contain reference to the "others" sector, which included the operations of BezeqCall Communications Ltd. and Bezeq On-Line Ltd. (see section 1.5 below).

1.3 Investments in Equity and Stock Transactions

In 2005, the State of Israel completed the process of sale of the core of its control of the Company, pursuant to the decision of the Ministerial Committee on Privatization, dated July 19, 2004, to the effect that the State's holdings of the Company would be sold by way of private sale of 30% of the share capital of the Company and the grant of options to purchase a further 10.66% of the share capital of the Company.

The State chose Ap. Sab. Ar., which offered NIS 4,237,000,000 for 30% of the share capital of the Company (781,513,683 shares) and an option to purchase an additional 10.66% of the shares of the Company (277,697,862 shares) as preferred offeror. Transfer of the State's holdings to Ap. Sab. Ar. required the receipt of consents under all laws, including the consent of the Prime Minister and the Minister of Communications, under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "**Communications Law**") and the Communications (Prescription of Essential Service Provided by Bezeq – the Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the "**Communications Order**"), and the consent of the Antitrust Commissioner under the Antitrust Law, 5748-1988.

On October 11, 2005 (after obtaining all of the consents required under the law), the aforesaid transaction was completed under the conditions set out in the agreement for sale of the State's holdings in the Company between the State of Israel and Ap. Sab. Ar. (and the holders of interests therein) of such date.

In consideration for the shares and options as aforesaid, the total sum of NIS 4,246,286,575 was paid by Ap. Sab. Ar.

Ap. Sab. Ar.'s shares in the Company are held in trust by Romema Investment Company Ltd.

According to information provided to the Company:

- A. Pursuant to the agreement with the State, Ap. Sab. Ar. purchased 30% of the State's shares in the Company and an option for the purchase of up to 277,697,862 of the State's shares in the Company (constituting approximately 10.66% of the share capital of the Company), on the conditions set out in the above agreement, as set out in the Company's immediate reports dated July 14, 2005 and October 16, 2005. The option is exercisable up until the first day of business 48 months after October 11, 2005 (the date of completion of purchase of the Company's shares).
- B. Pursuant to this agreement, Ap. Sab. Ar. shall be entitled to request that the State vote together with it (under the limitations set out in the agreement regarding certain matters) in respect of the 10.66% of the shares in the Company held by the State in respect of which Ap. Sab. Ar. has an option to purchase, and in respect of the 1.01% that will remain in the State's possession during the period commencing on October 11, 2005 (the date of completion of the transaction) and ending at the end of the option exercise period, and in respect of the 4.71% of the Company's shares held by the State and designated for allotment to employees of the Company (see section 2.9.6 below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

As a result of closing of the transaction, the Company was released from certain limitations that had been imposed upon it as a company under the control of the State of Israel, including repeal and/or amendment of some of the provisions of its Articles of Association which are similar to certain provisions of the Government Companies Law, 5735-1975. It is noted that on December 20, 2006, the Company replaced its Articles with new ones, in keeping with the provisions of the Companies Law and with the Company's status as a company not under State control. Prior to that replacement, the articles of the wholly owned subsidiaries of the Company have been amended such that, *inter alia*, the provisions regarding the number of members of the board of directors, proceedings for appointment of them, and provisions relating to the Government Companies Law (in the articles of former government subsidiaries) were deleted. Further to such, the directors of the Company's subsidiaries were replaced such that directors were appointed from the ranks of senior management of the Group, subject to the rules of structural separation in the Group.

1.4 Payment of dividends

- 1.4.1 In 2004 and 2005, the Company did not distribute a dividend to its shareholders.
- 1.4.2 Pursuant to a resolution of the board of directors dated March 1, 2006, resolutions regarding the distribution of dividends are to be passed specifically in accordance with the Company's financial results, financial state and the other relevant circumstances and data. This resolution substitutes previous resolutions regarding dividend policy.
- 1.4.3 Below are details of distributions made by the Company during 2006 and up to the date of publication of this Periodic Report:

Distribution date	Type of distribution	Total amount distributed (NIS)	Distributed amount per share (NIS)
16.4.2006	Cash dividend	1,200,000,193	0.4606446
30.10.2006	Cash dividend	400,000,064	0.1535482
9.1.2007	Cash dividend	300,000,179	0.1151612
26.2.2007	Cash dividend ⁹	1,800,000,030	0.6909668

1.4.4 Distribution of a cash dividend not in accordance with the earnings test

On December 28, 2006, the general meeting of the shareholders of the Company approved the recommendation of the Board of Directors of the Company to distribute a cash dividend of NIS 1,800,000,030 (amounting to NIS 0.6909668 per share), as a distribution which does not comply with the earnings test. The distribution was subject to the approval of the court, and on December 31, 2006, the Company filed an application in court for approval of the distribution. The court approved the distribution on February 4, 2007, and the distribution was made on February 26, 2007.

⁹ Distribution of a cash dividend not in accordance with the earnings test. See section 1.4.4 below.

- 1.4.5** It is noted that under the agreement between the State and Ap.Sb.Ar. for the sale of the controlling interest in the Company, Ap.Sb.Ar. undertook, *inter alia*, to operate by virtue of its holdings and not to make a distribution which was not from the accumulated retained earnings of the Company on December 31, 2000 (it was clarified that this would not prevent the distribution of earnings generated after December 31, 2000 in accordance with the Companies Law, 5759-1999). Ap.Sb.Ar. also undertook to operate by virtue of its holdings so that a distribution would not be made from the capital gains deriving from the realization of capital assets paid for in kind, for a period of two years from the date of purchase of the shares being sold.

1.5 Financial Information regarding the Group's Areas of Operations

1.5.1 2006:

	Domestic fixed-line communication	Cellular	International communication and internet services	Multi-channel television	Others	Adjustments to consolidated*	Consolidated
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Total Revenues:							
From externals	5,193,493	4,462,077	1,016,300	1,338,826	221,134	-	12,231,830
From other areas of operation in the segment	605,503	15,910	21,519	23,563	97,545	764,040-	-
Total	5,798,996	4,477,987	1,037,819	1,362,389	318,679	764,040-	12,231,830
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,687,452	3,625,410	820,458	1,209,302	324,006	-	10,666,628
Costs constituting revenues from other areas of operation	365,224	160,895	85,945	145,380	6,596	(764,040)	-
Total	5,052,676	3,786,305	906,403	1,354,682	330,602	(764,040)	10,666,628
Operating Income	746,320	691,682	131,416	7,707	(11,923)	-	1,565,202
Total identified assets as at December 31, 2006	9,756,868	3,375,001	454,918	838,793	186,391	172,230	14,784,201
Minority percentage in the segment							

* Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.5.2 2005:

	Domestic fixed-line communication	Cellular	International communication and internet services	Multi-channel television	Others	Adjustments to consolidated*	Consolidated
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Total Revenues:							
From externals	5,285,006	4,413,423	825,801	1,200,866	199,622	-	11,924,718
From other areas of operation in the segment	607,947	14,854	21,488	8,206	104,511	(757,006)	-
Total	5,892,953	4,428,277	847,289	1,209,072	304,133	(757,006)	11,924,718
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,591,737	3,660,312	670,151	1,182,920	292,662	-	10,397,782
Costs constituting revenues from other areas of operation	382,078	182,782	77,494	104,592	10,060	(757,006)	-
Total	4,973,815	3,843,094	747,645	1,287,512	302,722	(757,006)	10,397,782
Operating Income	919,138	585,183	99,644	(78,440)	1,411		1,526,936
Total identified assets as at December 31, 2005	9,638,637	3,591,679	525,114	941,693	218,100	198,372	15,113,595
Minority percentage in the segment			25.1% (Goldnet)			 	

* Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.6 General Environment and Effect of External Factors on Group Activity

The Group's business is affected by the level of the financial activity in the domestic market and therefore, positive or negative developments at this level are expected to have a corresponding impact on the business of the Group. Thus, for example, growth in the GNP and in the number of people employed in the market is expected to impact positively on Group revenues.

The Israeli communications market is characterized by a high level of concentration and a complex structure of cross-ownerships which are a fertile ground for the setting up of a number of communications groups operating on the basis of marketing cooperation between a number of companies and/or joint holdings for the supply of inclusive communications services, whilst exhausting the marketing and operating advantages that such a structure permits. Given the regulatory limitations imposed upon the group in the context of generation of cooperation between all of the members of the Group, and given the increasing competition on the part of the other communications groups, the Group is having difficulty providing appropriate responses to threats stemming from this sort of competitive structure.

2. Fixed-Line Domestic Communications – “Bezeq” – The Israel Telecommunications Corp. Limited (“the Company”)

2.1 General Information on Area of Operations

2.1.1 Area of activity and changes affecting it

The Company has a general license for the provision of fixed-line domestic communications services. Under this license, the Company provides telephony services, dial-up internet access and associated services; broadband internet access (ADSL); remote access; information services and data communications; transmission services; IP-VPN services; maintenance and development of infrastructures; internet access services between users and ISPs; and other activities, including sale of terminal equipment, satellite and video services, setting up and operation of radio and television broadcasting installations and services for external organizations (billing and collection services, deployment and maintenance of television cables, performance of engineering work, etc). In addition, the Company provides infrastructure and other services to other communications providers. Both in the global markets and in Israel, the pace of development in the telecommunications sector is rapid. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

2.1.2 Legislative and regulatory restrictions and special constraints

The Company's activity is subject to comprehensive regulation and control that relates, *inter alia*, to matters such as determining and approving the fields of the Company's permitted activity and services, holding and transferring of means of control, licensing, determining tariffs, quality and terms of service to subscribers and obligation to pay royalties. These regulations and controls are attributable to the following: the status of the Company as a licensee, according to the Communications (Telecommunications and Broadcasting) Law, 5742-1982 (hereinafter: the "Communications Law"), and are subject to the provisions of the Communications Law, as well as the regulations and rules that have been promulgated there under, and the terms of its general license. The Company's status as an essential telecommunications service provider is subject to the provisions of the Communications Order based on section 4D of the Communications Law; and other laws.

The tariffs for the Company's main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, *inter alia*, according to recommendations of the Committee for the Regulation of Bezeq's Tariffs. The Company's interconnect tariffs were reduced on July 1, 2006.

The Company was declared a monopoly in certain fields of activity, and is similarly subject to control and restrictions under the Antitrust Law, 5748-1988.

Furthermore, some of the Company's activities involve the use of wireless frequencies and the operation of facilities emitting electromagnetic radiation, which are subject, respectively, to the Wireless Telegraph Ordinance (New Version), 5732-1972 (see section 2.16.8 below), the Pharmacists Regulations (Radioactive elements and their products), 5740-1980, and the Non-Ionized Radiation Law, 5766-2005 (see Section 2.15 below).

With regard to this section, see also section 2.16 below.

2.1.3 Changes in the volume of activity and profitability in the field

	2006	2005
Revenues (NIS millions)	5,799	5,893
Operating Income	753	919
Average monthly revenue per line (NIS) (ARPL)(1)	99	100
Number of active subscriber lines as at the end of the year (thousands)	2,833	2,875
Total minutes of use in Israel (outgoing and incoming) (millions)	20,528	21,499

(1) Not including revenues from transmission and data communications services, services to communications providers, contractor work and other.

2.1.4 Developments in the market and in customer attributes

In recent years we have seen growing competition between fixed-line and cellular telephony. If in the past almost all calls were made between two fixed lines, today, more than 50% of calls are made in the cellular networks. As the number of cellular subscribers has grown and reached approximately 8.5 million subscribers (according to data published by the cellular companies), there has been a decline in the number of households and businesses holding a fixed line, as well as a decline in the number of lines per customer. Furthermore, there has been an ongoing average decline in the Company's regulated and unregulated tariffs (see Section 2.16.1 below). On the development of competition in the various domestic areas, see section 2.6 below.

2.1.5 Technological changes that significantly impact on the area of activity

A. Penetration of high speed internet and the availability of new IP-based technologies offer consumers a wide variety of applications and services over IP-based infrastructures, such as voice services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

The Company estimates that in the coming years the trend of increased bandwidth to the customer home or business will intensify. This will facilitate penetration of applications required for the transmission of a high volume of data at a fast rate as well as voice services that will enable regular phone calls over the Internet and/or IP networks. Regarding competition through the provision of telephony over the Company's broadband network, see Section 2.6.1 below. Given this trend, the Company needs to adapt its infrastructures so that it will be able to provide its customers with significant bandwidth that will guarantee availability and quality of service.

B. The development of standardization in this area makes it possible to use the infrastructure owned by the Company which is currently in place in order to provide higher quality telephony services than in the past, as an alternative to the telephone line services that the Company supplies to its customers.

C. The increase in the number and capacity of cellular networks, along with technological enhancements, enable cellular service providers to compete with the Company's services more effectively than with existing technologies.

D. In addition, wireless technology is being developed which opens the gateways for providing services that compete with the Company's services, in the area of voice calls as well as data communications and broadband internet, without the need to invest heavily in land-based access infrastructure.

E. Technological developments may enable other operators to build infrastructures that provide services similar to those offered by the Company at lower cost. Furthermore, as a result of the advances in technology on the one hand, and the aging technology implemented in the Company's systems, which may be difficult for suppliers to support, on the other hand, it may be necessary to switch to other technologies or to improve the existing systems.

2.1.6 Critical success factors in the area of operations and changes therein

A. The ability to offer reliable communications systems at a competitive price based on a cost structure that is adjusted to the frequent changes in the Company's business environment.

B. The ability to maintain innovation and technological leadership, and to translate those into advanced, reliable applications of value to customers, within short response times.

C. Technological and marketing innovation.

D. Efficacy of internal and external sales systems and distribution channels.

E. The ability to provide high quality commercial and technical service to customers of the Company.

- F. Management of an intelligent price policy, subject to regulatory limitations, in light of growing competition and technological changes that are expressed in generally lower prices in the industry.
- G. Intelligent migration of customers from traditional networks to next-generation networks.
- H. Maintaining brand values and adjusting them to the changing competitive environment.

2.1.7 Main entry and exit barriers of the activity and changes affecting such

The main entry barrier in the domestic fixed-line communications market is attributable to the need for substantial investments in technological infrastructure and complementary systems until economies of scale are achieved, and from the high costs involved in establishing marketing, sales and customer support systems and the construction of brands. In recent years the traditional entry barriers to the Company's areas of activity have been to a great extent removed, as a result of the following factors: Technological improvements, a decline in prices of infrastructure and equipment; easing of regulatory restrictions for new competitors, and in particular – the cancellation of the universal service obligation for select general license holders as well as leveraging of existing systems of communications operators that are competing or are planning on competing against the Company.

The main exit barriers are attributable to the following: the obligation of the Company, as stipulated in its license, to provide services at a defined quality of service on a universal basis; its being subject to the emergency regulations and the provisions of the Communications Order based on section 4D of the Communications Law; its obligation to some of its employees as part of collective bargaining agreements; long-term agreements with infrastructure providers; large investments requiring a long time to ROI; and an obligation to repay long-term loans taken to finance the investments.

2.1.8 Alternatives to and changes in products of area of operations

In recent years cellular communications services have to a large extent become an alternative to services offered by the Company, both in the area of telephony and in the area of data communications.

Recently we have seen a growing trend of transmission of voice calls over the internet or over public and private IP-based networks, using dedicated software that is provided free of charge or at a discounted price by companies in Israel and abroad. Furthermore, the internet enables e-mail applications and instant messaging, which to a certain extent are also alternatives to telephone calls. Recently, international software and internet companies have redoubled their efforts to integrate telephony services as part of the service packages that they provide to their customers.

In the area of transmission and data communications services, technological advances enable the provision of new services at high transmission rates and low prices.

2.1.9 Structure of competition in the areas of operation and changes therein

Fixed-line domestic services primarily include telephony services, internet access services, transmission services and data communications.

The area of transmission and data communications, particularly at high baud rates, was opened to competition at the end of 2000.

In the area of broadband internet access, cable company partnerships began to compete against the Company in March 2002.

In the field of telephony, Hot Telecom, a partnership of the cable companies the merger of reach was recently concluded (hereinafter: "Hot") commenced providing services on a commercial basis on November 25, 2004. As of September 2004, the Minister is entitled to grant special general licenses for the provision of domestic fixed-line communications services without the obligation to provide a service to everyone or to provide minimal deployment of it. Several such licenses have been granted to a number of bodies (see section 2.6.1 below). Furthermore, according to the amendment of the Communications Law in January 2005, the Minister is entitled to grant general licenses for telecommunications services or telecommunications activity and exemption by order of the licensing obligation. In November 2004, the Ministry of Communications published a policy

paper on the provision of telephony services over broadband access services (by the Company and by HOT). The policy was made subject to a hearing, and on January 31, 2007, the regulation and licensing policy for providing such services was published. With regard to this matter, see Section 2.6.1 below. The Ministry of Communications granted licenses for a "paid marketing trial" for providing these services, the validity of most of which ended a few weeks prior to the date of this Report. In this regard also, see section 2.6.1 below. Additionally, the Company views cellular telephony services as alternative services to the telephony services it provides. With regard to this matter, see Section 2.6.4 below.

Competition in the sector is dependent on a variety of factors, including: development of competition with HOT, issue of licenses to other domestic operators, implementation of the policy determined regarding provision of telephony service over broadband infrastructure, increased competition with cellular companies; possible changes in the terms of the licenses of the Company and its subsidiaries as well as the conditions of the licenses granted to their competitors; mergers and joint ventures between companies that compete against companies in the Group; financing of the universal service; new services the Company will be allowed to provide; tariff policy and the amount of flexibility the Company is given in offering service packages, including along with subsidiaries etc.

For a description of developments in competition, see Section 2.6 below.

2.2 Products and Services

2.2.1 The Company provides a wide range of communications services to business and private customers. The main services offered by the Company include telephony services, associated services, and value-added services, internet access services – both dial-up and broadband access to high speed internet, transmission and data communications services over a wide variety of infrastructures for businesses and other communications providers.

2.2.2 Telephony

The Company's telephony services include, mainly, basic telephone services via household telephone lines, installations and transfers of telephone lines, sale of terminal equipment and other auxiliary services such as: Voice mail, caller ID, 144 information service, call waiting, follow-me, abbreviated dialing and conference calls.

Furthermore, the Company provides number services for businesses that enable incoming calls from anywhere through a single short speed dial (asterisk plus four digits), and via the 1-700, 1-800 area codes. These area codes enable business customers to determine whether the company or the customer will pay for the call.

The Company currently operates approximately 12,000 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, but the draft was not approved by the Knesset Economics Committee, which resolved that the Ministry of Communications should submit a revised draft. To the best of the Company's knowledge, as at the date of publication of this periodic report the Ministry of Communications has not submitted an amended proposal, and in any event, no such draft has been presented to the Company.

On March 7, 2006, the Ministry of Communications announced a hearing for all the communications companies, in connection with the Ministry's intention that a joint 144 center be operated for all the companies, so that with one call, all the telephone numbers of a subscriber, with any carrier, are obtained. The service would operate in parallel with a similar service (all the numbers of all the carriers) on an internet site. In its reply written on March 26, 2006, the Company stated its position, arguing, among other things, that the information is an auxiliary service of the telephony service provided by the licensees, that entities without a general license should not be permitted to enter the sector, and that the service should be kept in its present format, as an auxiliary to the services of the general licensee. The Ministry of Communications accepted the Company's position that 144 is an auxiliary service.

On November 5, 2006, the Company license was amended so that, *inter alia*, commencing February 8, 2007, the Company is required to provide, itself or through another entity acting on its behalf, a telephone number information service of whoever is a subscriber of a

fixed-line or cellular operator, excluding unlisted numbers, for the general public and without payment via the internet and for its subscribers at a reasonable price through a service center. Since February 8, 2007, the Company has operated a unified service center, by a network code set by the Ministry of Communications (1344), including for the cellular operators and for HOT. This is additional to the Company's 144 service. It is noted that on February 7, 2007, a company that will become a telephone information service company in the future, filed a petition in the High Court of Justice against the continued provision of 144 services by the Company.

The Company's telephony services are among the main services provided by the Company, and in recent years they have been on a downward trend, in terms of both use and revenues. This is due primarily to the alternative services offered by the cellular companies and use of cellular phones which is, to a great extent, an alternative to making a call on a fixed-line phone.

2.2.3 Internet access services

These services enable internet access and primarily provide access to high speed internet over regular telephone lines using ADSL technology.

At the end of 2006, the Company had approximately 891,000 ADSL subscribers (compared with approximately 800,000 subscribers at the end of 2005), amounting to approximately 65% of the broadband internet market in Israel (based on items in the Israeli media regarding the number of subscribers who are not subscribers of the Company).

The high speed internet market is one of the markets that has shown the most growth in recent years, and this growth is reflected in the Company's business. As hundreds of thousands of customers have subscribed to high speed internet services over the past five years, this service has become one of the Company's main operations and a major channel for its investments in technology, marketing, advertising and customer acquisition.

The high speed internet market is also marked by fierce competition against HOT, which offers high speed internet services over cable infrastructures.

2.2.4 Transmission and data communications services

Data communications services are network services for the point-to-point transfer of data over the Company's infrastructures, transfer of data between computers and various communications networks, services to connect communications networks to the internet and remote access services.

Data communications services are provided over established traditional infrastructures such as digital and frame relay lines, as well as over innovative and advanced infrastructures including ATM and IPVPN (Virtual Private Network). The IPVPN infrastructure enables managed communications solutions for businesses by connecting the various branches of the organization. In recent years customers have been switching from data communications solutions provided over older traditional infrastructures to IP-based infrastructures.

The Company offers transmission services, including high speed services, to its business customers and communications providers over a variety of protocols

2.2.5 Other services

A. Services to communications providers

The Company provides services to other communications providers including the following: cellular operators; international operators; cable broadcasting licenses; the Israel Broadcasting Authority and The Second Authority for Television and Radio; network endpoint operators; ISPs; domestic operators; Palestinian communications providers.

Among the services provided by the Company are infrastructure services, connection to the Company's network, transmission services, billing and collection services, *inter alia* to international carriers, rental of space and provision of services at rented space, and provision of rights to use underwater cables.

B. Satellite and broadcasting services

The Company provides satellite services via fixed antennas (in the Ella Valley and the Ramla area), mainly including services for international communications: video

transmission services and satellite relay broadcasts for foreign broadcasting organizations in Europe and Asia. The Company also operates mobile units for television broadcasts via satellite from time to time. The Company is also in negotiations with customers for the provision of internet services via satellite.

Likewise, the Company provides users over a broad geographical area around the world with various kinds of mobile satellite communications services (such as: telephony, data communications and facsimile services) by operating a ground station for the provision of Inmarsat services in the Ella Valley. These services are granted by virtue of an agreement with Inmarsat Ltd. (which operates a satellite network that covers most of the world, land, air and sea). In this regard see also section 1.1.6 above.

The Company also currently operates and maintains seven radio networks operated by the Israel Broadcasting Authority, Channel 1's television transmitters and those of Educational Television, Channel 2's television transmitters and the transmitters of four regional radio stations. The Company is only responsible for operation and maintenance of the transmitters in order to distribute broadcasts of radio and television programs, and not for the content of the broadcasts. In this regard, see also section 2.15.2 below.

C. Work as a contractor

The Company performs setup and operation work on networks and sub networks for various customers (such as the Ministry of Defense, cable television companies, radio and television broadcasting companies, cellular operators, international communications carriers, local authorities, municipalities and government agencies).

There are agreements for the provision of installation and maintenance services of cable networks for cable television between the Company and two cable television broadcast licensees which were recently merged using the Company's infrastructure, from the starting point of the above licensees' operating point up to the point of delivery at the entrance to subscriber homes (the connection and maintenance from these points up to the subscribers' homes is not within the Company's responsibility).

D. IP Centrex

The IP Centrex service is a virtual private exchange service. The Ministry of Communications wrote to the Company requesting that the Company prepare a service portfolio for the purpose of provision of this service.

2.3 Breakdown of Revenues and Profitability of Products and Services

The following table provides data on the breakdown of the Company's revenues by the main products and services in its area of activity, which represent 10% or more of the Company's revenues (in NIS million and as a percentage of total revenues) over the past two years:

	2006		2005	
	NIS millions	% of revenues	NIS millions	% of revenues
Telephony	4,088	71	4,262	72
Internet	608	10	550	9
Transmission and data communications	711	12	691	12
Other services	392	7	390	7

2.4 Accounts Receivable

2.4.1 The Company is not dependent on any single customer or on a limited number of customers, which if lost would significantly impact on the area of activity.

2.4.2 The Company does not have any single customer generating revenues of 10% or more of its total revenues.

2.4.3 Company sales are divided into two main sectors: the private sector (approximately 63%) and the business sector (approximately 37%).

2.5 Marketing, Distribution and Service

- 2.5.1 The Company has marketing, sales and service systems for the private and business sectors, which include customer managers for the business sector, joint sales and service centers (including the 199 center) located throughout the country, separate technical support centers for internet and IT services, support and repair centers for telephone services (166 center), as well as 24 points of sale and service (Bezeq Store) around the country.
- 2.5.2 The Company primarily markets its services through advertising in the mass media and telesales centers, customer managers and through a system of independent marketers that includes ISPs, DBS, sales centers working by an outsourcing model, D2D and resale systems that operate points of sale in various shopping centers.
- 2.5.3 Under the new collective agreement signed between the Company and the workers' organization, the Company is currently restructuring its organization, based, *inter alia*, on a transition from a geographical structure to a functional, customer-focused structure. In this context, the geographical divisions have been cancelled, and two new divisions have been set up – a private division and a business division. In this regard, see also section 2.9.1 below.

2.6 Competition

As part of the trend towards mergers in the communications market, the mergers of Netvision, Barak and GlobeCall were approved, as was the merger of Internet Zahav and Golden Lines. In this regard, see also updates to sections 4.6.1.1 and 4.6.2.1 below.

The following is a description of the development of competition in the fixed-line domestic communications market:

The Grunau Commission for formulating recommendations concerning the policy and principles of competition in communications in Israel

In December 2006, the Minister of Communications appointed a public commission, headed by Professor Grunau, to formulate detailed recommendations concerning the policy and principles of competition in communications in Israel. The letter of appointment stated that the Commission is requested to formulate its recommendations, *inter alia*, on the following important issues: The question of the need to separate out sectors of operation (transmission / content); the issue of the operation of consolidated communications groups, including rules for structural separation imposed on the Bezeq group and others. The Commission would also discuss the marketing of service packages and tariff flexibility for the Company and access of competitors to the infrastructures of licensees, the Company, the cable company and others (while examining different models, such as breakdown into segments). The Commission would also discuss a format for regulation in a world of convergence of mobile and fixed communications and voice, video and data services, including broadcasting on the platforms of communications operators, such as ADSL, cable, cellular – whether IPTV or other methods. Another subject to be discussed is the extent of the universal service obligation imposed upon communications operators. The deed of appointment further states that the Commission shall be permitted to extend the list of issues, should it find that such are essential for the formulation of its recommendations.

At the beginning of January 2007, the public was invited to present positions on the subject and to comment on the above. The Commission started its work in February 2007. According to a notice of the Ministry of Communications, the Commission will submit its recommendations within about six months. The Company is formulating its position on the issues, which it shall present to the Commission. The recommendations of the Commission, which will relate to the most important issued for the market and for the Company, are likely to involve changes in the principles of competition currently in place, and the Company is unable to assess the related trends or influences.

2.6.1 **Telephony**

In November 2003, **HOT** was granted a license for the provision of fixed-line domestic services, including telephony. On November 25, 2004, Hot began to supply telephony services.

On August 1, 2004, a temporary order entered into effect, stipulating that for a period of two years from the date on which HOT began its commercial activities or until a difference of up to 1.05 billion traffic minutes is generated between calls that end on the Company's

network and those that end on HOT's network, whichever comes first, interconnectivity fees for termination of the calls on said networks would not be paid (the "Bill and Keep Arrangement"). After a hearing (conducted in writing) on the intention to extend the Bill and Keep Arrangement by nine months, the Ministry of Communications notified the Company, on December 4, 2006, that the Ministers of Communications and Finance were considering extending the benefit granted to HOT in that arrangement, in a different format of setoff from the royalties which HOT is required to pay to the State. The Company replied to the Ministry that extension of the arrangement, even in its proposed new format, is harmful to competition and the Company, and that it is tantamount to direct financing for a competitor by the State. The Company requested to present its arguments in a hearing, among other reasons because it contends that the arrangement and the subject are new. To the best of the Company's knowledge, no amendment to the Royalties Regulations has yet been brought before the Knesset Finance Committee (see Note 29 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report).

Competition with HOT is increasing, and is expressed, *inter alia*, in offers by HOT which combine broad band internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers. According to media reports, HOT's telephony service has more than 200,000 customers, as at the end of 2006.

The Company petitioned the High Court of Justice against the Minister of Communications, in an application for immediate enforcement on HOT of its obligations and commitments under its license, concerning structural separation. From the response of the State to the petition, it transpires that the Ministry of Communications had informed HOT that failure to implement structural separation constitutes a material breach of the terms of the license, and HOT was requested to notify the Ministry of its actions for fulfillment of its obligation for structural separation. In the hearing on the petition which took place on March 29, 2007, the Company reached an agreement with the State to the effect that the hearing of the petition would be adjourned by six months, by which time the State undertook that a decision would be passed by the Grunau Commission, and that the State would adopt the decision with regard to structural separation.

Following the adoption of the recommendations of the Kroll Commission, which was appointed to set guidelines for competition in the area of fixed-line telecommunications, and the accompanying legislative amendments, as of September 2004, the Minister is entitled to issue special general licenses for the provision of fixed-line domestic telecommunications services, including telephony, with no obligation to provide universal service or minimal geographical deployment. To the best of the Company's knowledge, such licenses were granted to GlobeCall limited partnership (which was merged with Barak and Netvision), Cellcom Fixed-Line Communications Services limited partnership, 012 Telecom Ltd. and Partner Fixed-Line Communication Solutions. The Company's subsidiaries Bezeq International and Pelephone have also applied for licenses (see sections 3.7.4 and 4.1.2.2 below).

VOB¹⁰Service Policy

On January 31, 2007, the Ministry of Communications published a policy for regulating and licensing the provision of VOB services. The policy replaces an earlier policy published by the Ministry in November 2004.

At the time of publication of the policy in November 2004, licenses were granted for marketing trials for VoIP services to a number of entities, including Golden Lines, Barak 013, and the subsidiaries Bezeq International and Pelephone. Most of the trial licenses remained in effect until publication of the new policy on January 31, 2007, however, the entities which have, in the meantime, received special general licenses for the provision of domestic fixed line communications services (see this section 2.6 above), continue to provide VOB services under those license. The trial license of the subsidiary Bezeq International was extended (see section 4.1.2.3 below). It is noted that the Company's request to the Ministry of Communications on March 16, 2006, for a marketing trial of VOB for payment (despite its clear position that is entitled to provide the service under the terms of its license), was turned down.

¹⁰ Voice Over Broadband

Under the new policy document of January 31, 2007, the Company and its subsidiaries will be permitted to provide VOB services only after the Company's market share in fixed-line domestic telephony in a particular segment (business or private) falls below 85% (the calculation of market share will be made according to the amended policy document – "Bezeq's License – Policy Highlights concerning Economies of Scale and Baskets of Services", dated January 9, 2005 – see section 2.16.2 below). Concerning DBS, the test point will be set on the day after the elapse of one year from the effective date (February 1, 2007), when the possibility of granting it a VOB license will be examined to see if its competitive status has deteriorated, and noting the situation of the competition in fixed-line domestic telephony.

On the matter of the call termination tariff in the network of a VOB operator, it was determined that it will be the same as the payment for call termination in a public telecommunications network of a fixed-line domestic operator (i.e. the same as the payment which the Company receives for terminating a call in its network), for a period of two years from the effective date. No later than by the end of two years, the Ministry will re-examine the arrangement, noting, *inter alia*, the actual development of competition in the field.

According to the policy document, the Company will also not receive additional payment from a VOB operator who uses its network, beyond the payment made by the end user for the broadband access service.

The regulation for the provision of a private organizational network in IP technology for transferring calls, will be similar to that for network end point services. In this context, the policy document notes that the Ministry of Communications intends to adapt the network end point service licensing policy for a body that is one legal entity even if not in continuous premises, and to consider expanding the use of the IP/VPN service to intra-organizational telephony.

An immediate report of the Company stated that the application of these decisions could result in significant harm to the Company and its subsidiaries and their ability to compete.

On January 31, 2007, the Ministry issued a directive whereby the Company and HOT are required to allow every special general licensee whose license permits it to provide the service, and every licensee for international telecommunication services whose license permits it to provide international services on broadband, access to the public broadband telecommunications network for providing the service. The directive also states that the Company (and HOT) will not demand additional payment from such special operator or international operator beyond the payment for connecting the ISP to the network, nor additional payment from the subscriber beyond the payment for the high-speed internet service.

The Company wrote to the Ministry of Communications several times, including a letter requesting temporary suspension of the directive until after an appropriate cost-based usage price could be set, and a letter concerning the policy, stating that denying the Company the ability to provide VOB services was unlawful and unreasonable, and even if a reason could be found for limiting the Company, it could not be done without delineating the limitation to a reasonable and concrete time period and not only market size. The Company also requested that the market shares be measured on the basis of minutes and not revenues. These letters have not yet been answered.

For the positions of the subsidiaries Bezeq International and Pelephone in this regard, see sections 3.7.4 and 4.1.5 below.

2.6.2 Broadband internet access

The field of broadband internet access has become fiercely competitive since the partnership of the cable companies (now "HOT") began competing against the Company in this area in March 2000.

HOT has access to a cable and fiber-optic infrastructure over significant parts of Israel and a relatively high penetration rate into homes in those areas. The cable network underwent a major upgrade recently and is currently an advanced broadband digital network. Over this network, it is possible to provide a wide range of advanced communications services and advanced interactive applications. This network is currently the main universal alternative for competition against the Company in the private sector.

The Company estimates, based on various items in the media, that HOT serves more than 470,000 high-speed internet customers on its cable network.

2.6.3 Transmission and data communications

At the end of 2000, segments of this area began to open to competition, as special licenses were granted for the provision of transmission services to licensees - Cellcom, Med-1 and Golden Lines. In November 2002, the licenses of Cellcom and Med-1 were expanded to include the provision of high-speed data communication services to organizations. The licenses prohibited the provision of voice, video and access services to ISPs as well as assistance in the doing of these actions in any manner whatsoever. At a later stage, these licenses were amended to allow Cellcom and Med-1 to provide access services to ISPs at symmetrical speeds above 2 Mb/s. Furthermore, to the best of the Company's knowledge, restrictions on Cellcom were eased somewhat with regard to the prohibition on provision of video services.

Cellcom has set up an independent backbone to connect its switches, which it uses for both its own purposes (instead of transmission which in the past was provided by the Company) and for competition against the Company in the transmission and data communications market.

HOT and Med-1 can be counted among the significant competitors in this market, given that they own a widely deployed fiber-optic network, as can the Internet companies which use leased infrastructures.

At the beginning of July 2006, Partner announced that it had concluded a transaction to acquire the transmission operations of Med-1. On August 15, 2006, Partner was granted a special license for providing transmission and data communication services, after purchasing the operations of Med-1 as aforesaid. Purchase of the operations of Med-1 by Partner might make competition in this field stronger, whilst harming the Company's revenues from services that it provides to Partner.

2.6.4 Competition from the cellular companies

The penetration rates of cellular technology in Israel are among the highest in the western world. The Company's opinion, which is not accepted by the Ministry of Communications or the Antitrust Commissioner, is that the penetration rate, combined with airtime tariffs which are low in international terms, have made cellular phones a product which is largely interchangeable with telephone lines. Over the past two years, there has been steady erosion, albeit at varying rates, in the number of voice minutes over the Company's network, as a result of a slow-down in the pace of growth of the cellular companies. There has also been an increase rise in calls from the networks of fixed-line domestic operators to the cellular networks. The Company believes that increasing interchangeability between fixed-line and cellular telephones is one of the reasons for the growing rate at which telephone lines are being removed, to the extent that approximately 15% of Israeli households today do not have a fixed line of the Company (compared to approximately 5% in 1996). Based on the Company's approach, that mobile telephony services are largely interchangeable with fixed-line services, the Company has appealed to the Antitrust Tribunal against the refusal of the Antitrust Commissioner to rescind the declaration of the Company as a monopoly regarding fixed-line telephony services. At the Tribunal's suggestion (in light of the time that has passed since the appeal was submitted together with an economic opinion), the Company agreed to withdraw the appeal, which was expunged on August 2, 2006. The Company is getting ready to submit a new, updated application to the Antitrust Commissioner.

Cellcom is operating in domestic communications market, and to the best of the Company's knowledge, Cellcom has deployed a fiber-optic infrastructure reaching, *inter alia*, industrial and commercial sites, office buildings and business centers. This infrastructure could be used by Cellcom to connect business customers to its installations in order to provide communications services as an alternative to the services the Company is currently providing to some of these customers. Entry into the fixed-line domestic telecommunications market may enable Cellcom to offer its customers a complete line of solutions, including domestic telephony, and data and cellular communications, while using its own infrastructure and sales system.

Partner Fixed-Line Communication Solutions has also been granted a license for providing fixed-line domestic services.

2.6.5 VOD¹¹ Service Policy

On January 10, 2007, the Ministry of Communications published a proposed policy for the licensing and regulation of VOD services over a broadband infrastructure. According to the document, it is proposed to amend the Communications Law so as to enable new licenses to be granted for these services. In addition, the document proposes that DBS be permitted to provide VOD services on the Company's ADSL infrastructure, with limitations that will apply with regard to that infrastructure: the Company will be required to allow a VOD licensee and DBS to use the ADSL infrastructure for providing VOD services on equal terms; the Company will be given usage instructions according to Section 5 of the Communications Law; and payment will be equal and transparent, and will include the cost deriving from connection of the service provider to the network.

Furthermore, the Bezeq Group – except for DBS – will not be allowed to provide VOD services, not will the Company be allowed to be involved in any other way in providing the services (including by way of marketing packages of services); and in the matter of the end user, the Company will offer a broadband access service to the VOD provider on equal terms. On this matter, two options are being considered: the subscriber will receive two bills – one from the Company and one from the service provider, or – the service provider will be a collection channel only.

The document also proposes that HOT be required to allow access to these licensees, if and when it requests to provide VOD services in IP technology.

On February 15, 2007, the Company submitted its position to the Ministry, stating that with the change in the condition prohibiting the Bezeq Group from being a VOD service provider, and where the policy encourages investment of the considerable amounts required for upgrading the infrastructures in order to realize the ability to convey content, the Company will act to make the necessary investments for providing the services, and will enable access also for other entities on equal terms. However, if this essential condition is not allowed, the Company will be unable, out of business considerations, to agree to the proposed policy, and does not intend to make the investments required for providing VOD services.

On March 15, 2007, the Ministry of Communications published its final policy document on the issue of VOD, to which no substantial changes were made compared with the proposed wording. The form of a proposal to amend the Communications Law so as to allow the grant of new licenses for the provision of VOD services was attached to the policy document.

In this regard see also section 5.6.5(f) below.

2.6.6 Additional factors that may affect competition

A. Numbering and number portability

Under the Communications Law, in order to guarantee competition and the level of service in the telecommunications market, the Minister is authorized to issue directives to licensees regarding designation and allocation of telephone numbers and dialing rules, preparation and management of a numbering plan, and its operation and application. The Minister may order each licensee to bear the costs, in whole or in part, it incurs in complying with the directives, and if licensees should incur shared costs in respect of number portability, the Minister may order that they be divided among the licensees. According to a directive issued by the Ministry of Communications, certain area codes in the Company's network have been unified.

On March 29, 2005 the Economic Policy for Fiscal 2005 (Legislative Amendments) Law, 5765-2004 was passed by the Knesset, containing, *inter alia*, an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (hereinafter: the "**Communications Law**"), whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006 (if the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone, in an order and with the

¹¹ Video On Demand services.

approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months).

Notwithstanding the countless letters, official reports and approaches by the Company other licensees and entities, such as the chairman of the Forum for Implementation of Number Portability, stating that it is not possible to comply with the timetable (and the Company also wrote to the authorities in this regard even before the law was enacted), no action was taken to postpone the dates and set realistic timetables for implementation of number portability.

In this regard, in January 2006, the chairman of the Forum wrote to the Minister of Finance requesting to hold a hearing for all of the carriers regarding the timetable, and proposed amending the Law so that completion of implementation would be postponed by one year.

During February/March 2006 there was a further exchange of letters with the Ministries of Communications and Finance on the matter of the operators', including the Company's inability to meet the timetables that were set. The Company reiterated that it is preparing for the implementation of number portability but for real and technical reasons, it cannot meet the timetable set for implementation of the plan, and it reserves its legal rights in this matter.

In June 2006, the Company once again applied to the new Minister of Communications, asking the Minister to act to enact an amendment to the Communications Law in order to prescribe a reasonable timetable for implementation of number portability. On August 2, 2006, a letter was sent to the Company from the Supervision Department of the Ministry of Communications, containing a summary of supervision regarding the Company's compliance with the number portability plan. According to the claims made in that letter, the Company is not in compliance with the timetables set for implementation of number portability, and the Company's explanations for such were not accepted. On August 8, 2006, a letter was sent by the Company in response to this letter, explaining that the summary of the discussion was not, in the Company's opinion, in accord with the spirit of the discussion on the matter, that the Ministry's good impression of the Company's acts was not expressed in the summary and that it had not been possible to commence making preparations earlier, prior to the formulation of a characterization plan, and prior to formulation of full characterization by the Ministry of Communications. On August 7, 2006, a letter was sent by the Chairman of the Number Portability Forum to the Minister of Communications, requesting the Minister to act to postpone the date of implementation of the plan.

It is noted that concurrently with the aforementioned correspondence, the Company is using its best efforts and is investing considerable resources in order to advance the implementation of number portability on its systems.

On August 23, 2006, the Ministers of Communications and Finance announced that implementation of the plan would not be postponed beyond September 1, 2006. The Ministers' notice also stated that the Director General of the Ministry of Communications had recommended that if the plan is not implemented and operated by that date, "the relevant communications companies would be declared in violation of the law, with everything that entails". Following this decision, on August 24, 2006 both the Company and Pelephone (as well as other cellular companies) filed petitions in the High Court of Justice for a decree nisi against the Government of Israel and the Minister of Communications. The petitioners allege, *inter alia*, that even though they had worked assiduously for implementation of the plan, investing considerable resources for the purpose, they are unable to meet the unrealistic timetables set in the law for its implementation. Moreover, the petitioners alleged that the Ministry of Communications had failed to prepare a number portability plan and had not prescribed a structure for the payments that would apply among the operators, as the Law requires. The State filed its preliminary response, in which it requested that the petition be dismissed *in limine*. The hearing of the petition has been postponed to July 30, 2007. On this matter, see also Note 17C to the financial statements of the Company for the period ended December 31, 2006, included in this periodic report.

The Company has given notice to the Ministry of Communications that, subject to the success of the testing being run between the carriers (which the Company has

undertaking to commence no later than July 1, 2007), the Company shall be prepared to implement the plan on December 1, 2007.

B. Other potential competing infrastructures

In addition to the cable companies' cable and fiber-optic network and Cellcom and Partner's fiber-optic infrastructures, there are a number of fiber-optic networks in Israel today, most of which are owned by State-owned companies or government agencies. These include Israel Electric Corporation, Israel Railways, Mekorot, the Oil Infrastructure Company and the Cross-Israel Highway Company. At this stage, there is no use of the aforesaid infrastructure in competition with the Company. Some municipalities are also attempting to create an alternative to the laying of pipelines by communications licenses, via the infrastructure held by such municipalities. During 2006, Tel Aviv-Yafo Municipality contacted the Ministries of Justice and Communications concerning the laying of infrastructures by communications companies within its jurisdiction and the use of municipal infrastructures, in an attempt to receive authorizations and impose additional restrictions on the communications companies in that context. The Company opposes the position of the Municipality, and submitted its comments to the two ministries.

On January 31, 2006, the Ministry of Communications published a request to receive public positions regarding the policy of allocation of frequencies to the wireless access network (WIMAX) by February 28, 2006. According to the Ministry, following applications from existing licenses and commercial entities for allocation of frequencies for the purpose of operating a wireless access system in order to provide a variety of fixed-line communications services, the Ministry is considering amending its policy on allocation of frequencies for the purpose of operating wireless access systems, which will enable the provision of fixed-line communications services. The Company submitted its position, is that there is neither room nor need for the allocation of those frequencies, which are a limited national resource, to operators with special licenses who are not obligated to provide universal service. The Company believes, that due mainly to the essential nature of these frequencies for providing services in periphery areas, the top policy priority for their allocation to wireless access systems should be the universal service and the creation of conditions that will enable it to be provided.

C. Advantages and technological developments

Cellular operators and international telecommunications service providers have a relative advantage when entering the area of provision of fixed-line domestic telecommunications services, given the existence of exchanges, switching equipment and customer base for telecommunications services.

The Company's assessment that real competition will develop in the market, harming market segments, rests on frequent technological developments and breakthroughs in the various fields of communications. Technological progress is expected to enable competing companies to introduce technology quickly at a relatively low cost, which will enable supply of telephony and data communications services over private and public IP networks, as well as via advance cellular infrastructure, and advanced generation wireless infrastructure.

Another competitive factor is the "Bezeq-bypass networks". There are two main types of bypass networks: (1) those built on the Company's infrastructure – primarily various types of point-to-point lines, such as Sifranet and frame relay which compress speech channels and are used by organizations dispersed over a large number of sites around the country, and use of the internet infrastructure; (2) those that use other infrastructures or divert traffic to them, and primarily different types of wireless-cellular, microwave, laser, satellite networks and cellular adaptors. Systems using a combination of both of these types also exist.

The rapid growth in the number of broadband internet subscribers, improved quality of sound and increasing awareness of use of the internet to make cheaper calls negatively affect the number of calls passing through the Company's network and are causing a decline in its revenues.

In the business sector there is also a common trend of bypassing the Company's switched telephony network, either through cellular adaptors installed by the customers themselves or by the cellular companies (installations on the customer's

premises enabling conversion of calls originating from a fixed line to the cellular spectrum) or by NEP licensees.

The Company believes that the said network bypasses along with the interchangeability of fixed-line and cellular services explain a substantial part of the decline in traffic minutes on its network. In addition to the technologies and methods described above, additional technologies and methods are being developed and are likely to be developed in the future, and these will even further reduce the use of the Company's telephony, data communications and transmission networks.

2.6.7 The Company's preparations for coping with increasing competition

The Company is coping with competition in fixed-line domestic telecommunications services in several ways:

- A. The Company is launching new communications services and value-added applications, among other reasons, to increase the volume of use of subscriber lines, respond to customer requirements and enhance the image of technological innovation. The Company invests in improving and modernizing its infrastructure in order to be able to provide its subscribers with advanced services and products.
- B. The Company took action to introduce broadband (high-speed) internet services using ADSL technology and is working to maintain its market share in this area. In December 2003, the Company launched the "IPVPN secured business access service", which provides secure connectivity of branches and enables employees to connect from their homes to their organization's network. It also launched an ADSL-based service for business customers and high-speed data communications services for business customers and communications providers.
- C. The Company is constantly working to improve the quality of its services and to preserve its customers, and since the end of 2005, these activities have been run as a special project, which focuses solely on them.
- D. The Company has simplified its tariff structure and offers customers a number of alternative payment packages.
- E. The Company is implementing a new billing system for business and private customers.
- F. The Company is working to heighten awareness of use of the fixed-line telephone and to promote the use of other services which increase telephone use, such as numbering services (1-800), voice mail, marketing of digital cordless phones (under the B Digital brand), telephone information services and other value-added services.
- G. The Company has entered into contractual arrangements with business customers for a defined period (generally three years, in rare cases – five years) to promote increased use of its services by assisting in the financing of communications equipment or annual financial bonuses in the form of discounts which the Company believes it is permitted to give. The Ministry of Communications' position was that these agreements contravene the provisions of the Company's license, and it informed the Company that if said agreements are not cancelled, it intends to call in NIS 8 million of the bank guarantee the Company provided in accordance with its licenses. The Company disputed the position taken by the Ministry of Communications and has appealed to the High Court of Justice in this matter. The High Court of Justice issued an order staying rescission of the existing agreements and the calling in of the guarantee pending hearing of the case.

On March 28, 2005, the High Court of Justice ruled that the interim order staying rescission of the agreements between the Company and business customers be left in place pending further ruling. However, in the same ruling, the High Court of Justice stated that there was nothing to prevent forfeit of the sum of NIS 8 million by the Ministry of Communications, out of the bank guarantee given to it by the Company. As at the date of publication of this report, the Ministry of Communications has not taken any action relating to forfeit of the guarantee. "Hot-Telecom" has been joined as a respondent in the petition. On November 17, 2005, a hearing was held in the petition, and as at the date of publication of this report, a ruling has yet to be handed down. On March 27, 2007, a judgment was handed down dismissing the petition. As a result of this ruling, the Company is preparing to rescind the agreements and has given notice of such to the Ministry.

- H. The Company is adjusting expenditures with the goal of focusing investments in fixed assets in growth activities and reducing operating costs. The Company has a policy of selective investments, effective utilization of existing resources and reducing the prices of the equipment and services it purchases. The Company has also changed the mix of its investments: less emphasis on investments for maintenance of existing items and heavier emphasis on development of growing services (such as ADSL and IPVPN), and the integration of advanced information systems for achieving its marketing and business-related goals. Notwithstanding the foregoing, the Company's ability to make adjustments in its expenses in the short and medium term is limited due to its cost structure, which mainly comprises rigid short- and medium-term costs. These costs consist principally of depreciation expenses and expenses related to salary and benefits. Furthermore, the Company has other operating costs such as infrastructure maintenance and leasing as well as maintenance of buildings, which are also rigid short-term costs.
- I. At the end of 2005, a change administration was set up at the Company in order to implement changes in the organizational structure of the Company, the purpose of which was to make the Company more compliant with a competitive market, by focusing on customers, and achieving operational and procedural efficiency. After execution of the new collective agreement, the Change Administration is acting in order to implement and assimilate the new organizational structure of the Company (see section 2.9.1 below).
- J. The Company is looking at how it will integrate itself into a process which is hitting most of the communications companies around the world, to deploy a unified infrastructure, under a network topology known as the Next Generation Network (NGN) for transmission of voice communications, high-speed internet communications and content, leisure and entertainment applications. With regard to this matter, see Section 2.6.5 below. The decisions of the Company on this matter will be taken subject to the regulatory policy on content, an issue which is included in the letter of appointment of the Grunau Commission (see section 2.6.1 above).

2.6.8 Positive and negative factors that affect the Company's competitive status

Positive factors

- A. A modern infrastructure that is deployed throughout the country and technological innovation through which a variety of services are provided.
- B. Presence in most businesses and households.
- C. Strong capital structure and positive cash flow.
- D. Expansive service infrastructure and various customer interfaces.
- E. Professional, experienced and trained staff.
- F. Brand with presence and power.
- G. Tariffs that are among the lowest in the world.

Negative factors

Regulation

The Company believes that the various restrictions imposed on it under the existing regulatory guidelines impede and will continue to impede its ability to compete in its areas of activity as competition increases. The following are the main restrictions in this regard:

A. Obligation of structural separation

Under its license, the Company must maintain full structural separation, in the form set out in the license, between itself and those subsidiaries and affiliated companies that are specified in the license. At this stage, these restrictions do not apply to the other organizations operating in the communications market, and thus put the Company in an inferior position. There is also a separation between the Company's operations and those of Pelephone due to the conditions of the merger approved by the Antitrust Commissioner.

B. Restrictions on the marketing of packages of services jointly by the Company and companies in the Group

The Company believes it should be permitted to offer packages of services jointly with companies in the Bezeq Group, when these types of packages are offered by its competitors. The absence of such an option is a major disadvantage in the Company's ability to compete.

C. Lack of tariff flexibility

The Company is restricted in its ability to grant discounts on its principal services and to offer differential tariffs. Even the tariff packages (which were supposed, among other things, to offer an immediate alternative to the normal tariffs) are so tied up in bureaucracy that they are frequently pointless.

Furthermore, the combination of the present supervisory mechanism and the restrictions that apply in relation to the structural separation, prevent any possibility of the Company being able to offer customers packages containing all communications services.

The Ministry of Communications has started to intervene in marketing campaigns offered to the public by the Company, a position to which the Company objects since it is permitted to launch such campaigns for limited periods without having to obtain the prior approval of the Ministry.

D. Universal service obligation

The Company is obligated to provide universal service to the entire public in Israel. This obligation will not be imposed on the special local carrier licensees, which will be able to offer their services to the Company's profitable customers (particularly business customers), which represent a significant source of revenues for the Company. The Company believes that a fund should be established to finance this universal service, so that a carrier that does not provide service to any party requesting it will pay into the fund through which the universal service will be funded.

E. Cross-subsidy

Due to regulation, the Company's tariffs include a cross-subsidy between traffic and access. This issue is in any case one of the most substantial difficulties the Company has in competing, and yet the competition relies on Bezeq's infrastructure and takes advantage of the access subsidy (such as VOB Services), so the negative impact of this factor has grown. As noted in the preamble to this section 2.6, in December 2006, the Grunau Committee was set up to formulate recommendations regarding policy and rules of competition in the field of communications in Israel, which is to recommend changes in the above.

Labor relations

Labor relations in the Company, some of whose employees are subject to collective labor agreements, make flexibility of its operations and its ability to deal with competition more difficult.

Competition

The extent to which competition impacts on the Company (including positive implications) and on its revenues is dependent on a variety of factors, including the following: the rate at which competition with HOT and other domestic operators develops; increased competition with cellular operators; carriers providing telephony services over broadband infrastructure; the ability to leverage the synergy between companies in the Group and the flexibility the Company will be given to offer joint packages of services and to determine its tariffs; tariff erosion; approvals for new services, and allowing the Company to implement applications, services and transfer of content enabled via advanced technology (such as: IPTV), combination of fixed-line and mobile services; financing of the universal service; changes in licenses; symmetry in structural separation obligations; implementation of economies of scale; the Company's ability to retain and increase its portion in the various areas in communications.

2.7 Property, Plant & Equipment

- 2.7.1 The Company's fixed assets primarily include: domestic telecommunications infrastructure, exchanges, various networks, real estate (property and buildings), computer systems, vehicles and office equipment.

2.7.2 **Fixed-line domestic telecommunications infrastructure**

This infrastructure is comprised of five principal components deployed throughout the country.

A. Exchanges

Used for switching calls and transferring them from their origin to their destination based on the signal (dial) received from the subscriber.

B. Transmission network

A system through which there is connectivity between exchanges. This system actually functions as a national backbone that connects the local networks, which each comprise an exchange and an access network. The transmission network is based primarily on fiber-optic systems and in part (minimal) on radio systems.

C. Data communications networks

Networks for the provision of data communications services at various speeds.

D. Access network

A system that connects subscriber network end points to the exchange. The network is based on copper pairs, fiber-optic cables and in part (minimal) on wireless systems.

E. Terminal Equipment

Equipment installed at the subscriber site (such as telephones, private exchanges, fax machines, modems, routers, etc.) through which the subscriber receives the service.

2.7.3 **Computing**

The Company's IT system supports four central areas:

A. Marketing and customer management

The computing system supports, *inter alia*, management of the customer database, management of orders of services, management of follow-up of customer complaints, management of sales and customer service processes, and billing. The billing and collection system includes production of bills to customers for services provided and for services of other communications carriers. This includes the managing of accounts with communications suppliers.

B. Information systems for engineering infrastructures of the telecommunications networks

Support planning, management, control and maintenance of engineering resources for the purpose of supply and assurance of services. *Inter alia*, the systems manage the number inventory and support massive conversions of numbers and equipment.

C. Information systems for management of Company resources

Support management, control and maintenance of the expenses of the Company, financial information (including budget and controls), procurement and inventory processes, property, real estate, human resources and wage controls, vehicle fleet, Company projects, etc.

D. Cross-organization systems

Support decision-making processes via a data warehouse system (DWH) operated by the Company. The Company also has an internet site which provides information regarding the Company's services, and allows for the presentation of information regarding telephone bills, payment of telephone bills and additional services. Computerized office systems (electronic mail, resolution follow-up, etc.), knowledge management systems, etc. are also operated by the Company.

The IT system is made up of hardware (physical infrastructure, computers and various other kinds of equipment) and the information system (software, applications, information systems, etc.). The hardware system includes a central computer, a collection of servers, information storage units, a communications network and a collection of terminal stations which serve all of the units of the Company. the information structure, which is made up of a collection of information systems, operates in various computing environments, the components of which are linked in many ways.

The Company's IT system is large and complex, supports mission-critical work processes and handles very large amounts of data. The system is made up of a large number of systems, some of them old systems developed many years ago, operating on central computers, and some of them modern systems developed and implemented in recent years, operating in open computer environments.

2.7.4 Real Estate

A. General

The Company's real estate assets come from two sources: Assets transferred to it by the State under an asset transfer agreement in 1984 and assets to which the Company received or purchased rights after this date, including assets it leases from third parties.

The Company owns or has long-term leases over some 415 real estate assets around the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights), amounts to some 710,000 m² of land, of which some 370,000 m² is built up. Six of these properties are in Israeli settlements in Judea and Samaria, approximately 7,000 m² in area, with a total of 500 m² being built up.

In addition to those properties, there are another 14 properties, with a total area of 1,585,000 m², which are set out, in the agreement for the transfer of properties, as being under leases renewable every two years, and under the settlement agreement described below (hereinafter: the "**Settlement**"), this land is to be leased to the Company.

Of all of the properties owned or leased long-term, 66 of them are properties which were under joint title with the Ministry of Communications, the rights of the Ministry in most of which having been transferred to the Postal Authority, to the best of the Company's knowledge. The total area of these properties is some 126,000 m² of built-up land on plots totaling close to 130,000 m² (according to the data set out in the agreement for the transfer of properties). On June 30, 2004, The Company entered into an agreement with the Postal Authority to define and clarify the rights of both in these properties (see Section 2.17.2(c) below). The parties are following the provisions of the agreement, *inter alia*, to separate joint charges and systems.

Furthermore, the Company holds some 75 properties in Israeli settlements in Judea, Samaria and the Gaza Strip, in a total area of approximately 10,500 m² of land, on which about 1,800 m² is built up. No written arrangement of the contractual rights in these properties exists, but in the Company's opinion, this does not constitute a significant problem.

The Company uses this land for communications operations (switchboards, concentration rooms, broadcast sites, etc.) and for other operations (transmitters, warehouses, etc.). Some of the Company's properties are partially undeveloped or partially development, and can be exploited further.

The Company leases about 130 land assets, with a total area of 75,000 m², of which 72,000 m² are built-up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (i.e. in order to erect transmitters and deploy cables). The Company also has about 330 concentration rooms at its disposal (rooms for cables and installations for the purpose of neighborhood communications), with a total area of approximately 4,400 m², most of which are not regulated by written arrangements of rights with the owners (such as: The Israel Lands Administration, settling organizations, entrepreneurs of projects on which the properties are situated, and cooperative house committees).

B. Registration

As of the date of this periodic report, the Company's rights in a considerable portion of its land assets are not registered with the Land Titles Registration Office and are therefore merely contractual rights. The Company is in the process of registering those land assets which can be registered in the Land Titles Register.

C. The Settlement regarding the Land

On March 10, 2004, the Settlement signed by the Company, the Israel Lands Administration (hereinafter: "ILA") and the State was given the force of a judgment after a drawn out dispute over most of the real estate assets transferred to the

Company under the real estate transfer agreement which was executed when the Company began its commercial operations.

Under the Settlement, 14 properties specified in the agreement will be returned to the State through the ILA on different dates (by 2010) and in accordance with the terms stipulated in the agreement (hereinafter: "Returned Assets"), out of the 31 assets in the asset transfer agreement which will be under leases that will be renewed every two years. Three additional properties in this category were returned to the ILA prior to the Settlement. Fourteen additional properties in this category which were specified in the agreement (hereinafter: the "Properties to be Retained"), are to remain in the Company's possession, under capital lease conditions.

As at the date of publication of this periodic report, of the abovementioned assets, the Company has returned 13 assets to the ILA.

In addition to the Properties to be Retained by the Company, about 220 properties under long-term leases stipulated in the real estate transfer agreement (hereinafter: the "Properties under Long-Term Lease"), with the exception of a number of properties of an insubstantial cumulative value, are to be returned to the State. Of all the properties under long-term lease, 66 are held jointly by the Company and the Postal Authority and/or the Ministry of Communications. It was determined that the rights of the Company in these properties under the Settlement will also be determined by the area in the use of the Company in said properties as will be determined or agreed upon in the future between the Company, the Postal Authority and/or the Ministry of Communications, as applicable (in this regard, see Section 2.17.2(c)). Note that over the years (both before and after the Settlement), the Company has sold approximately 20 assets (in whole or in part) out of the properties under long-term lease, such that as at the date of this periodic report, there are approximately 200 assets in this group of assets.

D. Properties with improvement potential

Pursuant to a settlement agreement which removed uncertainty regarding the rights of the Company in the assets that the Company retains, and defined them, the Company started working on exercising the improvement potential of them, such as by exploiting construction rights, amending plans under the Planning and Building Committee, and selling assets. The considerations are mainly based on criteria of the size, location and use of the real estate.

During the course of 2006, the Company sold 14 real estate assets in a total area of approximately 986,000 m² in land and approximately 13,200 m² built-up, for a total sum of \$ 46 million.

2.8 Intangible assets

2.8.1 The Company's general license

The Company operates under the terms of a general license which, *inter alia*, serves as the foundation for its fixed-line domestic telecommunications activity (for a description of the principles of the general license, see Section 2.16.2 below).

2.8.2 Trademarks

The Company uses trademarks that reflect its products and services.

As of the date of this periodic report, the Company has approximately 90 trademarks registered in its name at the Registrar of Patents and Trademarks. The main trade marks are:

"Bezeq" – Company name.

"B BEZEQ" – Company logo.

"WOW" – access to the Company's high speed internet services.

Advertisement of the main trademarks is done in the various media outlets such as the press, radio, television, billboards and mailings.

The investment in advertising the trademarks is intended to increase the level of public exposure and awareness of the trademarks in order to create differentiation which will have an effect on customer purchasing decisions and preferences.

2.9 Human Resources

2.9.1 Organizational Structure and Employees According to Organization Structure

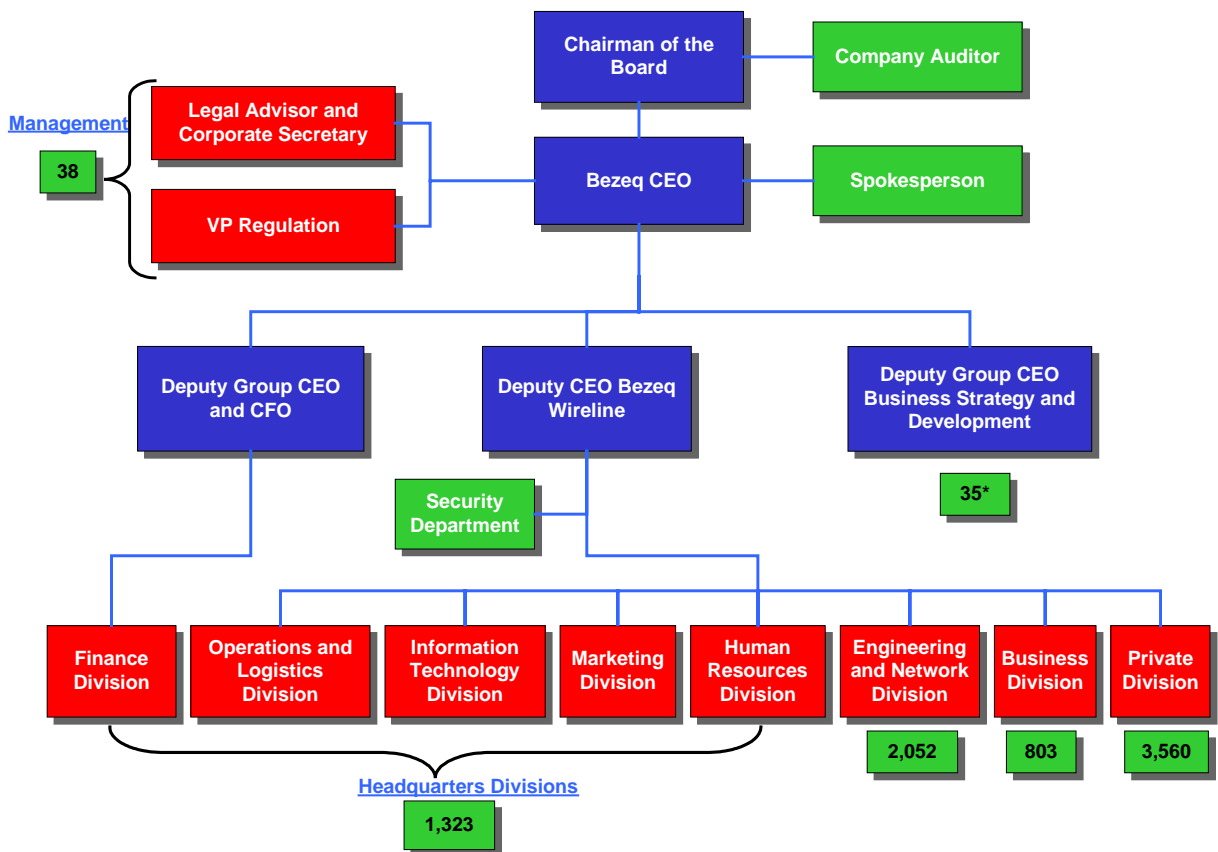
During 2006, the Company worked in coordination with the workers' organization in order to bring about a change in the Company's organizational structure, with the aim of making the Company compatible with the competitive market in which it operates, by focusing on the customer and achieving operational and procedural efficiency.

As a result, on December 5, 2006, a new special collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company. The main points of the agreement are set out in section 2.17.4 below.

A change administration is working in the Company on concentrating and coordinating the change plan, is responsible for designing the new organizational structure, for designing the new processes, for determining the necessary human resources and job descriptions, and for preparing the implementation and adaptation plan. The change administration is also responsible for defining indexes and goals and coordinates the work of all of the Company's improvement teams operating on a variety of core issues.

The new collective agreement provides, inter alia, that a total organizational change would be made in the Company based, inter alia, on a transition from a geographical structure to a functional structure, which would be implemented gradually over two years.

The following is a sketch of the general organizational structure of the Company after the changes:



* Including employees of the Inmarsat unit at the Company

2.9.2 Personnel according to employment framework

Employment Framework	Number of Employees		Description of Employment Framework
	As at 31.12.06	As at 31.12.05	
Contracts for senior executives	84	87	Managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.
Permanent	3,929	3,992	Employees employed through collective bargaining agreements.
Overall salary contracts / personal contracts	1,114	1,012	Employees employed through personal contracts that are not part of the collective bargaining agreements.
Ranking contracts	279	264	Employees employed through personal contracts under the terms of the collective bargaining agreements for a period of six years on a track that will make them permanent employees.
Age contracts	36	36	Employees who have a right to permanent status after reaching the age of 48. Instead of granting these employees permanent status, they are employed through personal contracts, under the terms of the collective bargaining agreements.
Temporary hourly employees & temporary monthly employees	2,258	2,702	Employees engaged in defined activities, which in the past were staffed by workers from employment agencies. The conditions of employment of employees in this category were recently updated in the special collective agreement of December 5, 2006.
Hourly agreement	383	0	Employees employed under an hourly agreement as of July 11, 2006.
Temporary	13	15	
Total	8,096	8,108	

2.9.3 Orientation and retirement of employees from January 1, 2006 through December 31, 2006

Employment Framework	Intake	Retirement
Senior Contracts	12	16
Permanent		107
Ranking contracts		12
Temporary		1
Overall salary contracts	45	98
Temporary hourly employees & temporary monthly employees	561	772
Hourly agreement	489	113
Total	<u>1,107</u>	<u>1,119</u>

Note that between January 1, 2007 and March 31, 2007 approximately a further 400 employees retired from the Company.

2.9.4 Company investment in training

The Company conducts internal training sessions given by professional experts who are Company employees and at times, with the assistance of external organizations, in all its areas of activity. The total number of workdays allocated for training activity for all employees in 2006 was approximately 28,500 days, reflecting an average of 3.1 days of

training per employee. This training activity includes, professional training in the fields of technology, sales, management, service and others.

The Company operates a service school that works to instill a service-oriented culture and customer-centric service values, as well as providing knowledge and skills in the provision of excellent customer service.

The Company's total investment in training activity in 2006 amounts to approximately NIS 2.4 million and approximately NIS 0.9 million for higher education.

2.9.5 Nature of employment contracts and streamlining plans

Labor relations at the Company are regulated, in addition to regulations in labor legislation, by the collective bargaining agreements between the Company, the representatives of Company employees and the New General Federation of Labor (hereinafter: "Histadrut") and personal contracts. Additionally, expansion orders to certain general collective bargaining agreements apply to Company employees. These include agreements on cost-of-living allowance.

For a list of the significant agreements with respect to labor relations, see Section 2.17.4 below.

2.9.6 Employee Reward Schemes

On November 15, 2005, the Company published an outline of an offer of the State's shares to employees of the Company. The offer is for up to 122,697,648 options, exercisable for up to 122,697,648 shares of the Company held by the State of Israel and constituting approximately 4.71% of the shares in the Company, and exercisable in three equal portions after approximately two years, three years and four years following the date of allotment. In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

On February 22, 2007, the board of directors of the Company approved an employee option scheme and on the same date, the Company published an outline with respect to the scheme.

Under the scheme, the Company shall issue its employees with options exercisable for shares at 3% of the issued share capital of the Company, at an exercise price (adjusted for each kind of distribution etc.), of 50% of the last closing price of the share prior to the date of issue, (apart from senior management staff), for no consideration, in accordance with criteria prescribed in the collective agreement of December 5, 2006.

Accordingly, on March 25, 2007, the Company allotted 78,091,794 options (out of a total sum of 78,151,368 options¹²) to employees, exercisable for 78,091,794 ordinary shares of the Company of NIS 1.00 par value each at an exercise price of NIS 3.201 per share, linked to the CPI for February 2007 (adjustments for all kinds of distributions etc. shall apply to the exercise price). The options shall be blocked for a period of two years as of the date of issue of them, and shall be exercisable over three years from the end of the blockage period.

The total value of the benefit to the employees under this scheme, according to the opinion of an external economic adviser, and based on the price of the Company's share as at February 18, 2007, is approximately NIS 170 million. However, the recording of the expenses for this scheme for accounting purposes cannot take into account the effect of the obstruction arrangements in the options, and therefore, the Company has recorded the sum of approximately NIS 287 million as a salary expense in its financial statements (see Note 26 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report).

In addition, the new collective agreement provides mechanisms for the payment of annual incentives (bonuses) in accordance with criteria prescribed by management.

¹² The rest of the options shall be issued to two directors from among the employees, subject to and following the approval of the general meeting of the shareholders of the Company, which is expected to take place on April 15, 2007, at an exercise price of 50% of the share price on the date of issue of the options.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 16 directors¹³ and -13 senior executives.

The two external directors acting on the board of directors of the Company receive remuneration in accordance with the Companies (Rules Regarding Remuneration and Expenses of an External Director) Regulations, 5760-2000. The other directors of the Company, apart from the chairman, do not receive any remuneration or salary for their office as directors. The chairman is an employee of the Company (see section 12 of chapter D in this periodic report).

For the management agreement between a management company owned by the shareholders of Ap. Sab. Ar., see section 2.17.5 below and Note 29(e) to the Company's financial statements for the year ending December 31, 2006, included in this periodic report.

The senior members of management are employed under personal agreements which include, *inter alia*, pension coverage, the payment of bonuses based on goals and prior notice months. The Company intends to act to approve a remuneration scheme for directors instead of the option scheme which was cancelled on March 15, 2007.

For cancellation of the bonuses to the members of management of the Company, see section 7 of Chapter D in this periodic report, and Note 29 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

2.10.1 The main raw materials used by the Company are: exchanges, copper cable, fiber-optic cables, transmission equipment, data communications systems and equipment, servers, routers and XDSL routers. The Company purchases most of the equipment required for its communications infrastructures from Israeli companies connected with communications equipment manufacturers from around the world. The Company purchases hardware and software from a number of main suppliers. Most of the equipment purchased for data communications, switching, transmission and radio systems is unique equipment, and it is only possible, over the years, to receive support services from the manufacturer.

2.10.2 The following table lists the percentage of Company purchases in 2006 from the main suppliers and the type of contractual arrangement with them:

Main Products	Main Supplier	Type of Contractual Arrangement	% of Purchases out of Total Purchases in Area of Activity
Public switching equipment	Nortel	Framework agreement for purchase, upgrade and maintenance, which was renewed at the end of 2004 until the end of March 2007.	Approximately 8%
Public switching equipment	Alcatel	1. Agreement to purchase equipment 2. Agreement to purchase number portability system, with option to upgrade existing switches. 3. Maintenance agreement that renews each year.	Approximately 10%
Billing – computerized billing systems	Amdocs	Framework agreement for the provision of personnel for support, guidance and integration of the systems.	Approximately 9%
Transmission equipment	Supplier D	Framework agreement for purchase and maintenance until the end of March 2008.	Approximately 8%
IP/VPN – IT equipment and integration work	Supplier E	Framework agreement that can be extended each year until the end of October 2010.	Approximately 6%

¹³ Including two external directors and two directors from among the employees.

2.10.3 The Company believes that it is dependant on two suppliers of public switching equipment: The Alcatel group, represented in Israel by Alcatel Telecom Israel Ltd. and The Nortel group, represented in Israel by Nortel Israel (sales and marketing) Ltd. In terms of the Company's billing systems for business customers, it is dependant on Amdocs Software Systems.

2.10.4 In order to perform the obligations regarding number portability between the various communications licensees, the Company is in various stages of contracting or performing projects with various suppliers, including purchasing new systems and making adjustments to existing systems. The contracts include purchases of new computer and switching systems, and effecting changes, adjustments and upgrades of existing systems used by the Company to provide services to its customers, and in enveloping systems used by the Company to support these systems.

2.11 Working capital

2.11.1 The Company's policy is to maintain positive working capital. The cash and cash equivalents component and short-term investments in working capital are generally significant and designed to allow the Company flexibility in its activities.

2.11.2 The inventory purchased by the Company is for the most part intended for investment in fixed assets. The Company's inventory policy strives to maintain an inventory sufficient for its needs for three months, with flexibility for special cases according to the nature of the consumption and price of the item. Orders from suppliers are made taking into consideration past demand and forecasts for the future.

2.11.3 The follow table presents data on supplier and customer credit in 2006:

	Scope of average credit in NIS millions	Average credit days
Accounts Receivable	867	EOM + 16
Accounts Payable	362	EOM + 29

2.12 Investments

For information on investments in subsidiaries, see Note 32 to the financial statements for the year ended December 31, 2006, which are included in this periodic report. See also Sections 3 and 4 in Chapter 4 of this periodic report.

2.13 Financing

2.13.1 Average interest rate on loans

As at 31 December 2006, the Company is not financed by any short-term loans (less than one year).

The following is a breakdown of the loans from banking and non-banking sources:

Source of financing	Type of currency or linkage	Rate of average interest
Non-banking sources	CPI linked NIS	4.7%
	Euro ¹⁴	6.5%
	NIS-Linked Euro	EURIBOR + 0.8%, i.e. 3.24763% as at December 31, 2006.

2.13.2 Restrictions on receipt of credit

A. With respect to limitations on Company loans – see Note 13 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

¹⁴ See section 2.13.7 below.

Note that following repayment of the balance of the long-term dollar loan in the NIS equivalent of NIS 430,000 [sic], the Company's obligations regarding the restrictions imposed upon it under the above loan agreement, including the obligation to comply with a net financial debt ratio to operating profit before depreciation (EBITDA) of no more than 3:1, for the Group.

B. Restrictions imposed by the Bank of Israel regarding individual borrowers and groups of borrowers

Directives issued by the Supervisor of Banks in Israel include provisions according to which the liability of an individual borrower or group of borrowers for a banking institution shall not exceed 15% (individual borrowers) and 30% (group of borrowers) of the banking institution's capital. These provisions further stipulate that total liabilities of the banking institution's six largest borrowers and groups of borrowers shall not exceed 35% of the banking institution's capital. These provisions may, from time to time, affect the ability of some banking institutions to issue additional credit to the Company. However, as a rule, the Company does not have difficulty finding sources of finance. As the Company does not have data and exact information regarding the restrictions on individual borrowers that apply to the banks, and given the fact that the Company cannot quantify a portion of its liabilities to the banks, such as debentures issued by the Company and held by the banks, the Company is not able to estimate when and at what level of debt, if at all, these restrictions will impact on the Company's ability to secure credit.

2.13.3 Credit received during the reporting period

No loans were taken in 2006.

2.13.4 Credit received after December 31, 2006

The Company has not taken any loans since December 31, 2006.

2.13.5 Variable interest

The following table outlines the Company's loans and debentures with variable interest rates (in NIS millions, as at December 31, 2006):

Type of linkage	Change mechanism	Financial scope	Interest range in 2006	Current interest rate
Euro and Euro-linked	Libor – EUR 6M	30	2.62650%- 3.24763%	3.24763%

Note: "Interest range" and "current interest rate" are the variable interest rates, not including the spread.

2.13.6 **Credit rating**

The Company is rated by four credit rating agencies. The following is a list of the ratings of each of the rating agencies:

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Maalot	AA	March 28, 2005 – AA rating received (no change in rating) May 10, 2005 – rating on Watch List. April 4, 2006 – Company's existing rating (AA) ratified and validated after renewed checks of the commercial risk, the financial risk and the Company's strategy, and following sale of the core of control of the Company to Ap. Sab. Ar. Holdings Ltd.	All series of debentures*
Midroog	Aa1 (Watch List)	March 24, 2005 – Rating changed from Aa1 (Watch List) to Aa1 (Negative). May 16, 2005 – rating moved to Watch List for examination of possibility of downgrading rating. April 11, 2006 – rating taken off the Watch List and left at Aa1. Rating forecast lowered from stable to negative so as to reflect the possibility that a change in ownership of the Company might affect the Company's future commercial and financial profile.	Debenture series (4) and (5)
Standard & Poors	BBB+	May 10, 2005 – rating moved to Creditwatch, with negative implications. October 11, 2005 – credit downgraded to BBB and to remain on Creditwatch, with negative implications. February 28, 2006 – rating remains on BBB+ and rating taken off Creditwatch. Rating forecast negative.	The rating is for the Company
Moody's	Baa1	March 7, 2003 – change of rating from A3 (Stable) to A3 (Negative). October 11, 2005 – rating downgraded to Baa1 and kept on review for possible further downgrade. February 6, 2006 – rating left at Baa1 and held to be stable.	Eurobonds

* Note: The rating is both for the issuer (the Company) and for the debenture series issued.

2.13.7 **Estimate of raising funds in the coming year (2007) and sources of financing**

The Company is expected to repay part of its loans during the course of 2007. The main sum to be repaid stems from repayment of the principal of the Eurobonds which is due to fall in August 2007, in the sum of approximately NIS 1,630 million. The Company intends to raise additional debt in 2007, *inter alia* in order to repay the Eurobonds. The financing options open to the Company are: Raising debt by the sale of series 5 debentures held by a wholly-owned subsidiary, Bezeq Gold (Holdings) Ltd., raising debt by new loans from banking corporations and/or by raising debt or capital on the capital market.

2.13.8 **Liens and guarantees**

For information regarding the Company's liens and guarantees, see Notes 13 and 19 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.14 **Taxation**

For information regarding taxation, see Note 8 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.15 Environmental matters

2.15.1 Regulations on facilities emitting electromagnetic radiation and proposed legislation

The Pharmacists (Radioactive Elements and their Products) Regulations, 5740-1980, regulate, among other issues, electromagnetic radiation from facilities that emit such radiation, and apply to some of the Company's facilities (including wireless communication facilities and the broadcasting stations it operates for the radio and television broadcasting authorities). Establishing such facilities, as stated in the foregoing, and dealing in this, require, *inter alia*, a permit from the Commissioner of Environmental Radiation at the Ministry of the Environment. The Commissioner may make the permit contingent upon certain conditions. Failure to conform with regulations or conditions stipulated in the permit is cause for cancellation or suspension of the permit.

2.15.2 The Non-Ionized Radiation Law, 5766-2006

On January 1, 2006, the Non-Ionized Radiation Law, 5766-2005 (the "**Law**") was published and most of the provisions came into force on January 1, 2007.

The Law regulates the handling of sources of electromagnetic radiation (hereinafter: "Radiation Source"), the erection and operation of them and supervision of them. *Inter alia*, the Law provides that the erection and operation of a radiation source will require a permit; imposes penal provisions and severe provisions with respect to liability of officers; imposes recording and reporting obligations on a permit-holder and grants the Commissioner for Radiation supervisory powers, including with respect to the conditions of the permit, cancellation of the permit and removal of the Radiation Source. Note that the Company's installations, such as broadcast installations or wireless communication installations, are included under the definition of Radiation Source.

The Law also sets out provisions regarding broadcast installations for cellular communications (hereinafter: "**Cellular Installations**") only, under which regulations are to be made within one year of publication of the Law, regarding safety distances from cellular installations and regarding the procedures for applying for building permits for cellular installations.

The Law includes Amendment No. 75 to the Planning and Building Law, 5725-1965, which provides that a planning institute is to be entitled to demand, as a condition for the grant of permits to erect cellular installations, deeds of indemnity against claims for compensation under section 197 of the Planning and Building Law, 5725-1965, and until provisions are made in this regarding the National Outline Plan, such demand shall be in accordance with the guidelines of the National Planning and Building Council. This provision applies as of the date of publication of the Law.

Further to the aforesaid amendment of the Planning and Building Law, on January 3, 2006, the National Planning and Building Council decided to instruct the local planning committees that, as a condition for the grant of a permit for a cellular installation, they must demand that an applicant for such a permit give a deed of indemnity at a rate of 100% of compensation payments that the committees may be charged with in claims under section 197 of the Planning and Building Law, if so charged, for harm due to the erection of a cellular installation. The form of the deed of indemnity was attached to that decision. The decision is in force until provisions are made in this regard in the National Outline Plan, NOP 36.

For the decision of the National Planning and Building Council of January 3, 2006 regarding the method of amending NOP 36 as aforesaid, see Section 2.16.11(d) below.

Under the Law, applicants for an operations permit must implement the conditions of grant of the permit as of January 1, 2007, including the conditions regarding presentation of a building permit under the Planning and Building Law.

The Company has radiation permits from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment for all of the communications sites operated by it, with a few exceptions. With respect to those broadcast sites the radiation permits for which are about to expire, but for which no building permit was found, the Company received radiation permits for a number of sites from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment, and is in the process of receiving radiation permits for the remaining sites as well.

The Company has work procedures with respect to the set-up, operation and measurement of non-ionized radiation sources, and an appropriate compliance procedure which was approved by the board of directors of the Company.

For the references in the Law and the implications of the Law to cellular installations, see also 3.18.1.3 below.

2.15.3 With respect to permits for broadcasting installations that are required by the Planning and Building Law, 57251965, see Section 2.16.11 below.

2.15.4 With regard to claims filed regarding alleged radiation from the Hillel broadcasting station – see Note 17A(5) to the financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.16 Restrictions on and regulation of Company operations

The Company is subject to a variety of laws which restrict its commercial operations. The principal body that supervises the Company's operations as a communications company is the Ministry of Communications.

On April 6, 2005 a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the parties that participated in the process of privatizing the Company. As set out in the document, it contained explanations of the main questions raised by the entities that participated in the privatization process, based on the Ministry's present policy of promoting competition in communications and in the provisions of the law and existing licenses, and noted that such should not be grounds for expectation or reliance on the part of the participants.

The main points of the clarifications in the document appear in an immediate report of the Company dated April 11, 2005. As the Company noted in that report, it believes that the clarifications contained in the Ministry of Communications Clarification Document did not significantly reduce the regulatory uncertainty in which the Group and the Company operate. In addition, in the Company's opinion, there has been no progress in a number of issues, the examination of which the Ministry of Communications announced in its clarification document, and it has given notice to the Ministry that these delays are making it difficult for the Company to make preparations for the increasing state of competition.

2.16.1 Regulation of Company tariffs

The arrangements under Sections 15 through 17 of the Communications Law apply to Company tariffs.

A. During the course of 2005, the following amendments were made to legislation regarding the Company's tariffs:

1. On April 11, 2005, an amendment to the Communications Law was published under the Economic Policy for Fiscal 2005 (Legislative Amendments) Law, 5765-2004, which set out a uniform supervision mechanism (tariffs being set by the Minister of Communications with the consent of the Minister of Finance), with respect to the Company's supervised services.
2. This mechanism is set out in section 15, which provides that "The Minister, with the consent of the Minister of Finance is authorized to determine by regulation the payments for services provided to subscribers by the Licensee." (Hereinafter: the "supervised services").
3. In an Order dated May 31, 2005, the application of the Supervision of Prices of Commodities and Services Law, 5755-1996 was cancelled, having previously applied to part of the supervised services and having prohibited a person from selling a service during the course of his business at a price that is different from the price fixed.

B. The tariffs for the Company's supervised services, stipulated in said regulations are updated using a linkage formula, less an efficiency coefficient, as set forth in the regulations and based on the recommendations of public committees for the review of the Company's tariffs.

C. Pursuant to section 15A of the Communications Law, if tariffs are stipulated for the supervised services under the above section 15, the Minister may, with the consent of

the Minister of Finance, approve the request made by the Licensee for an “alternative payment basket” for a package of services.

- D. Under Section 17 of the Communications Law, “a Licensee may request a reasonable payment for a telecommunications service for which no payment is stipulated in Section 15.” For these types of services provided by the Company (including broadband internet access service, business access, etc.) the Company sets tariffs and informs the Ministry of Communications of them in accordance with its general license. For additional provisions of the general license regarding tariffs, see section 2.16.2C. below.

2.16.2 The Company’s general license

The Minister’s policy paper

On March 31, 2004 a comprehensive and far-reaching amendment was made to the Company’s general license, by virtue of which the Company, *inter alia*, operates. The then Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages. On January 9, 2005, non-significant changes were made to the policy paper. The following are the principles of the paper, after its amendment:

Volume discounts - Once a competing domestic operator begins providing commercial telephony services, the Ministry will permit the Company to grant volume discounts of no more than 10% of the payment stipulated for the service, under Section 15 of the Communications Law. Such size discounts will be determined by way of an alternative basket of payments according to Section 15A of the Law. The discount shall not apply to the services for which discounts higher than 10% are set today in the regulations. Note that on May 24, 2006, an additional payments package (in force as of June 1, 2006) was approved by the Ministers of Communications and Finance, which allows the Company to give volume discounts of up to 10%.

Basket of services - Once the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85%, the Company’s license will be amended so as to enable it to submit an application for the Minister’s approval to market a basket of services in that customer segment, which includes telecommunications services provided by the Company and by a subsidiary, including broadcasts. The Minister’s approval to market a basket of services will be granted on the status of competition in the area of telecommunications or broadcasts. The Minister’s approval to market a basket of services will be granted, *inter alia*, on the basis of the following: (1) The existence of a group of services in a similar format, sold by a competitor as a package; (2) the Company and the subsidiary allowing customers to purchase any service included in the basket of services separately on identical terms to those offered in the basket; (3) that the basket of services be offered to customers on an equal and non-discriminatory basis. If even before the Company’s fixed-line telephony market share falls below 85%, a material deterioration occurs in the competitive status of a subsidiary of the Company, stemming from marketing a package of services that includes, among other things, telephony by a competitor, the Minister will consider amending the Company’s license as stated above.

In the Company’s opinion, the conditions that will enable it to sell joint service bundles with its subsidiaries as set out above, divest such bundles of all content.

In the clarification letter sent by the Ministry of Communications in April 2005 to bidders in the process of privatizing the Company (see preamble to Section 2.16 above), the Ministry stated that the reporting format for measuring market volume would include, as well as the central parameter of revenue, other relevant parameters as well such as numbers of subscribers, lines, call minutes, etc.

On March 15, 2006, the Company submitted a detailed position paper to the Ministry of Communications, in which it clarified that the requirement of loss of “market share” is vague and would be a broad basis for disputes, delays and legal actions; in the Company’s opinion, the conditions for allowing the Company to market joint bundles with its subsidiaries have also come to fruition.

The Company has submitted the professional opinion of an external expert to the Ministry of Communications, which states that the appropriate test for measuring market shares is the minutes test rather than the revenue test. However, the Deputy Director General,

Economics, at the Ministry of Communications has given notice to the Company that he does not intend to hold a hearing on this matter with the Company. The Company wrote to the Ministry once again on December 7, 2006, asking to hold professional proceedings between the Ministry and the Company.

On September 12, 2006, the Company wrote to the Ministry of Communications reminding the Ministry of its request of March 19, 2006 that the Ministry handle the grant of relief to the Company regarding supervision of its operations in the areas of operation in which the Company's market share has fallen to less than 85%, as a matter of urgency. On October 3, 2006, the Ministry replied that it was examining the request with respect to high-speed internet, and that it would respond soon.

On September 19, 2006, the Company wrote to the Minister of Communications requesting that it fulfill the provisions of the clarification paper for candidates in the proceedings to privatize the Company, dated April 6, 2005, under which the Ministry intended to set down two "checking stations", the first in November 2006 and the second in November 2007, at which the Ministry would check the possibility of allowing the Company to sell service bundles which also included services provided by subsidiaries, even if the Company has not lost a market share of 15%. The Company requested that the aforesaid check be effected as soon as possible. On September 26, 2006, the Ministry responded to the Company stating that the check would take place based, *inter alia*, on the data regarding competitor operations in the domestic fixed line field, in the period of up to and including October 2006. To the best of the Company's knowledge, no check was performed on the first checking station as aforesaid, and in any event, the Company did not receive any notice with respect to such. For the permit to the Company and its subsidiaries to provide VOB services after the Company's market share in the field of domestic fixed-line telephony falls below 85%, see section 2.6.1 above.

Highlights of amended license

A. Extent of the license and obligation to provide universal service

The Company is mandated to supply basic services, ancillary and other services as set forth in the appendix to the license; the term of the license is not limited in time; the license anchors the Minister's existing powers under the Law, to modify, revoke and suspend the license; the Company is required to supply its services to all persons, on equal and nondiscriminatory basis with respect to each class of service, regardless of the location or the unique cost. Generally, service that has started to be supplied will be supplied to every party requesting it no later than 12 months after the provision has begun.

B. Rules of structural separation

The Company must establish a structural separation between it and a "subsidiary", the definition of which, for this purpose, includes Pelephone, Bezeq International, DBS, Bezeq On-line, and Bezeqcall Communications, and GoldNet which have, in the meantime, been merged into Bezeq International. (The Minister has the authority to expand the application of the rules of structural separation to an affiliated company¹⁵, if it has been established that there is a real fear of injury to competition or to the public). Full separation between the respective managements of the companies, including all matters relating to the respective business, financial and marketing systems; full separation of the assets; and a prohibition against employing workers of the Company in the subsidiary and workers of the subsidiary in the Company; and also includes a prohibition on the transfer of commercial information to a subsidiary (where the definition of "commercial information" was expanded to include commercial information about the Company). No employee of the Company may be appointed a director of a subsidiary, if, within the scope of his duties in the Company, he has access to "commercial information" concerning a competitor, the use of which by the subsidiary could damage competition between it and the competitor. This limitation on appointment does not apply to the chairman of the board of directors of the Company).

The Company must set rules and procedures to preserve the confidentiality of commercial information on licensees competing with the Company's subsidiary, and it

¹⁵ Parent company, subsidiary, interested party, affiliated company, related company or partner.

is prohibited from transferring said information to the subsidiary. The Company has set such rules.

C. Tariffs

Should the Director General (according to the license: The Director General of the Ministry of Communications or a person authorized by the Minister with respect to licenses in general or with respect to this license in particular, as a rule or for a specific issue) announce that the Minister intends to set a tariff for a new service in accordance with Section 15 of the Communications Law, the Company shall not begin provision of the service before a tariff has been specified, unless the Minister so permits. The Company shall not charge a discriminatory price.

The Company shall provide service or package of services, in respect of which no tariff is stipulated under Sections 15 or 15A of the Law, at a reasonable price, and shall offer them to any person so requesting, without discrimination, at a uniform tariff.

When the Company collects payment for the services of another operator, it shall do so according to its own tariffs without any increment, and the tariffs for calls between the Company's subscribers and those of other domestic carriers, will be uniform and accordingly inclusive.

With respect to charging payment by standing order, credit card, prepayment or the deposit of a security - it was provided that as a rule, the Company shall not be entitled to demand that payment necessarily be made by these methods, with the exception of corporations or subscribers that have not effected payment within 21 days twice during one year. A new subscriber who does not have a bank account may also be required to prepay or deposit a guarantee of up to NIS 200.

D. Investments in other fields and restrictions on cooperation

A provision has been added allowing the Company to invest in any calendar year up to 25% of its annual earnings (not including the income of companies linked to the Company) in activity not designated for provision of the Company's services. The Minister is also entitled to authorize this percentage to be exceeded.

The Company's entering into agreements for performance of services through another licensee requires the Director's approval and contractual arrangements for performance of telecommunications services or telecommunications operations in conjunction with another licensee or broadcasting licensee requires the Minister's approval.

The Company shall not conduct any activity and shall not be party to any agreement, arrangement or understanding which is designed or which might limit or harm competition in the field of telecommunications. The Minister may direct the Company on the steps to be taken in order to prevent harm to competition in the field of telecommunications or broadcasting.

E. Numbering and number portability

For the numbering plan and number portability, see Section 2.6.6A above.

F. Operation of Company networks and service levels

The Company must maintain and operate the network and provide its services 365 days a year, around the clock, including at times of emergency, in a regular and proper manner, commensurate with technical requirements and service quality. The Company is also bound to work towards improving its services.

G. Interconnectivity and use

Infrastructure services - the Company will supply such services to another licensee such that it will be to meet the requirements of its license, under reasonable and non-discriminatory conditions, avoiding preference in favor of a licensee that is an affiliated company. New provisions have been made regarding provision of essential information which another licensee may need in order to receive service from the Company, and in order to supply services so as to enable it to meet the service level requirements imposed upon it and so as not to discriminate between recipients of the Company's services and the other licensee's customers.

Interconnectivity - new provisions were included which are essentially designed to enable the implementation of interconnectivity between the Company's network and that of another public network. Similar provisions exist with respect to providing the option of use to another licensee.

H. Arrangements in the field of security

Provisions were included for operation of the network in times of emergency. The Company is to set up and operate its network in a manner which will prevent its collapse at the time of emergencies and enable a reduction of activity in certain sectors.

The Company is to perform telecommunications services and set up and maintain the end equipment infrastructure for the security forces in Israel and abroad, as provided in agreements with the security forces. The Company will further supply special services to the security forces as set out in an appendix, which is top secret. The Company will take action to ensure that each purchase and installation of hardware in its telecommunications installations, except for end equipment, will be made in full compliance with instructions that are given to the Company according to Section 13 of the Law.

The Company shall appoint a security director and fully comply with the security instructions contained in the appendix to the license (Israeli requirements, security clearance for the appointment of certain officers, nondisclosure of classified information, including to a shareholder, if the revelation contradicts the security provisions, board meetings discussing security issues, guarding secrecy, protecting systems and limiting reporting or publication pertaining to the provision of classified service to the security forces).

For the Bill to amend Section 13 of the Communications Law so that the prisons service be included as part of the security forces, and to add section 13A to the Communications Law dealing with the power of the Minister of Communications to instruct a licensee in terms of emergency, see Section 2.16.12 below.

I. Liability and insurance

Detailed provisions have been added regarding the obligation to insure the Company's liability.

J. Control and reporting

Wide-ranging reporting duties have been imposed on the Company, such as filing the reports specified in the license and on-demand reports on various matters.

The Director has also been granted authority to enter facilities and offices used by the Company, and to inspect and copy documents and demand information and reports from the Company.

K. Miscellaneous matters

The general license includes "cross-ownership" restrictions.

Neither the license nor any part thereof is transferable, or may be made subject to a charge or lien.

Under the amendment to the license, the Company is to prepare a draft contract it intends to offer to subscribers, and shall submit such to the director for review, upon the demand of the latter. The Director shall have the authority to order changes. The Company is in the process of preparing said contract.

The Company must provide a bank guaranty to secure performance of the license conditions and indemnify the State for any damage that may be incurred by it following the breach thereof, such guarantee to be in an amount equal to US\$10 million. The Company has furnished the guarantee as required. The Minister shall be entitled to forfeit the guarantee or part thereof, on the conditions set out in the license.

Under the provisions of the Law, the Minister of Communications has the authority, at any time, to revoke, limit or suspend a license, if, for among other reasons, performance of telecommunications activity or provision of telecommunications services by a Licensee do not conform with the standard and at a proper level of

similar activity or service, in accordance with the rules stipulated in the Law, or if the Licensee is in material breach of the terms of the license.

The Director General of the Ministry of Communications is authorized to impose a monetary sanction on breach of any of the terms of the license. For the increase of the sum of the sanctions, see section 2.16.13 below.

On December 23, 2004, the Ministry of Communications amended the Erotic Services Appendix to the Company's license, and the definition of "erotic service" was expanded in the licenses of the cellular operators. The meaning of a service being defined as an erotic service is that it is being subject to rules determined by the Ministry in this matter, including requirements for blocking. On June 8, 2005, the Ministry of Communications provided a draft appendix to the general licenses to the cellular licensees, HOT and the Company, for remarks, regarding replacement of the "erotic services" appendix with "adult services". Under the draft appendix, a variety of services that are not appropriate for minors, due to their nature and substance, will be regulated by way of use of access code 1919, instead of what the Ministry sees as the restricted arrangement of "erotic services". The proposed amendment extends the content that may be offered via the aforesaid prefix to all "adult services" such as introductions, chats, matchmaking, etc., and prescribes clear rules for "reliable identification" of an adult prior to removal of the block. The Company, without going into the main body of the matter, asked that the requirement to play a voice message to all subscribers blocked from the service not apply to a licensee which does not itself produce the service, since the technology by which the Company currently provides access to the service, and which was adopted based on the previous amendment to the license, does not enable this.

On December 30, 2004, the Ministry of Communications began a process of amendments across all general licenses. The goal is to make the provisions and wording of similar sections in all general licenses uniform, as there is no real justification for the differences between them. As a rule, in terms of the Company, this consists of a small number of revisions which are not significant compared to the existing license.

On July 14, 2005, the Company's general license and the licenses of other operators were amended. The amendment to the license prescribed that the Company must act in accordance with the Israeli Standard regarding reliability of bills and due disclosure in telephone accounts. In addition, provisions that are different from those in the aforesaid standard were prescribed regarding rounding off of sums in bills. Under the amendment, the provisions of the standard regarding due disclosure in telephone bills came into force by October 14, 2005, whilst provisions relating to reliability of billing came into force by January 14, 2006. The Company's license was amended in this manner, despite the fact that the Company expressed its opinion to the Ministry that there is no room or justification for the standard in its proposed format, and certainly not for changing it, by adopting it in the license, into a binding standard, bypassing the statutory mechanism set out in the Standards Law. Likewise, the Company clarified that implementation of the standard involves investment of considerable resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be done at the same time as implementation of the number portability program, and that it needs a longer period of time to implement the standard. The Company is prepared to implement the standard in accordance with the amendment of its license, however, at the same time, it contacted the Ministry of Communications and gave notice to it that it would not be able to meet the dates set out for implementation of the standard in full under the amendment of the license, and asked that the matter be presented to the Ministry in order that the Company's request for a longer preparation period may be re-examined. On October 16, 2005, the Director General of the Ministry of Communications notified the general licensees, including the Company, that in light of the importance of the matter to consumers, there would be no delays in implementation of due disclosure. In this regard, the Company informed the Ministry, once again, on November 28, 2005, that the components required under the standard appear in the account produced by the Company with the exception of a particular component, which shall be completed upon completion of development of the Company's billing system, within one year, as the Company announced prior to amendment of the license, due to technological realities and special difficulties. In the interim, until completion of such, the Company publishes its principal call tariffs in a prominent manner which, in its opinion, means that it is in compliance with the standard.

On October 18, 2006, the Ministry of Communications published a hearing for general licensees regarding the intention to regulate the issue of a “fixed transaction”, by amendment of the licenses, to the effect that notices would be given to customers regarding termination of the obligation period, and the tariff to apply thereafter. Prima facie, the amendment imposes an operative burden on the Company, and it intends to express its reservations to the Ministry in this regard.

2.16.3 Royalties

The Communications Law stipulates that Licensees for the provision of telecommunications services shall pay royalties to the State of Israel on its revenues from the provisions of telecommunications services at a rate to be determined by the Minister of Communications and the Minister of Finance and approved by the Knesset Finance Committee. The rate of royalties stipulated in the Law is 11%, but the provisions allow other rates to be stipulated.

The regulations that entered into effect on January 1, 2001, Telecommunications (Royalties) Regulations 5761-2001 (hereinafter: the “Royalties Regulations”), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscriber services in the Schedule to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. The revenues on which royalties must be paid as stipulated in the Schedules are as follows: For a Licensee providing fixed-line domestic telecommunications services (including the Company) – from January 1, 2004 – 3.5% on all revenues from the provision of telecommunications services that are attributable to charges of recipients of the Licensee's services, less revenues collected for another Licensee or which were transferred to another Licensee, or payments made to another general Licensee for completion of calls or their transfer on its telecommunications network, and less revenues from the provision of transmission service to other Licensees, revenues from a segment of transmission service via satellite, revenues from the sale of terminal equipment and bad debts related to revenues on which royalties must be paid. On August 31, 2006, an amendment was published to the Royalties Regulations regarding a reduction of the rate of royalties for all of the licensees who are required to pay royalties, as of January 1, 2006, in the rate of 0.5% per annum, up to a royalty rate of 1% per annum as of 2010. Likewise, the Ministry gave notice that it would act to amend the regulations so that the Company would be given a retroactive exemption as of January 2004 from the obligation to pay royalties for its revenues from services opened to competition.

On March 20, 2007, a draft amendment to the Royalties Regulations was sent out to the general licensees, as sent to the Minister of Finance for the purpose of obtaining his consent. The draft added a section exempting a domestic carrier from paying royalties for income from the provision of data communication services, management of a data communications network and PTP lines at high baud rates and certain types of links, where one of the parties is a corporation, as of January 1, 2004. Likewise, the amendment contains a provision regarding deduction of revenues and payments from the basis of royalty-attracting revenues, under which a licensee is not entitled to deduct an income component if such component is not included in the calculation of royalty attracting revenues, and the licensee is not entitled to deduct payments unless they are not ascribed to income included in the calculation of royalty attracting revenues. The amendment also contains an exemption from payment of royalties for the revenues of international carriers from data communications services, the duty to pay arrearage interest in the event of consolidation, and an amendment of the definition of “licensee” so as to include a broadcast licensee, in order to enable a domestic carrier to deduct its revenues from the provision of transmission services, even when the service is provided to a broadcast licensee.

The Economic Policy Law, published on April 11, 2005, imposes license fees and royalties to the collection of fees under the Communications Law and The Wireless Telegraphy Ordinance (New Version) 5732-1972 (hereinafter: the “Telegraphy Ordinance”) and the Tax

Ordinance (Collection) 1929. The significance of the amendment is the addition of a means of enforcing said payments.

2.16.4 Authority with respect to real estate

According to the provisions of Section 4(F) of the Communications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law. Until the Law was amended in 2001, this Chapter did not distinguish between public and private land, and enabled the Company and the persons it authorized for purposes of providing telecommunications services, to enter any real estate in order to carry out surveys and examinations required for planning a telecommunication installation, and for examining, repairing or making changes thereto or therein. In most cases, prior notice was required to be given to the occupier of the real estate and the latter could appeal to the Court.

Amendment No. 25 of the Law, of 2001, distinguished between land owned by the State, the Development Authority, the Jewish National Fund, a local authority or corporation established by law and which was owned by one of them, and a road (hereinafter: "Public Land") and other land (hereinafter: "Private Land"). With respect to public land, the Company and any person authorized by it, may enter and perform work on the land, provided that approval for deployment of the network has been granted by the local planning and building committee. The local committee must decide on a request to approve such a plan within 60 days of it being filed, and in the absence of a decision, the plan will be deemed to have been approved. In most cases, it is necessary to give the occupier 21 days' advance notice and the latter may appeal to the Court.

Deployment of a network on private land requires the consent of the landowner or the long-term lessee or protected tenant, depending on the circumstances. In a condominium, the consent of a majority of the apartment owners is required. Notwithstanding the above, the Law contains provisions regarding the deployment of a network in a condominium at the request of an apartment-owner, even in the absence of the consent of a majority of the apartment-owners, while providing powers to the condominium committee and the Condominium Inspector.

2.16.5 Immunities

The Minister of Communications granted the Company certain immunities as listed in Chapter Nine of the Law, pursuant to his authority to grant immunity to a general license holder.

A Licensee granted immunities according to Chapter Nine of the Law (hereinafter: an "Immune Licensee"), its employees and all persons acting on its behalf shall not bear liability in tort, except:

- (1) For direct damage caused by the restriction or discontinuance of a telecommunications service;
- (2) For damage arising out of an intentional act or gross negligence of the Immune Licensee, its employees or persons acting on its behalf.

Under the Communications Law, an Immune Licensee, its employees and all persons acting on its behalf shall not bear liability for damage caused:

- (1) By non-provision, delay, restriction or discontinuance of telecommunications services and accessory services as arises out of an intentional act of the Immune Licensee insofar as such act is necessary to the performance of a telecommunication operation or the provision of a telecommunications service;
- (2) By an error in providing a telecommunications service, an error or omission in a telecommunications message, non-delivery of or a delay in delivering a communication message, delivery of a telecommunication message to a wrong address or an incorrect entry in a subscribers' directory or other publication of the licensee, unless the same is due to gross negligence.

Under Section 13 of the Law which relates to the provision of telecommunications services to the security forces, a licensee or any of its employees shall bear no criminal or civil liability for any act committed in the performance of a direction to be given according to said Section, except in circumstances in which the State employee bore liability for the act. (Under the Civil Wrongs Ordinance, in any action other than negligence, a public servant

will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority).

2.16.6 Regulations and rules under the Communications Law

As at the date of this periodic report, regulations in three main additional areas apply to the Company: (1) the termination, delay or restriction of a telecommunications operation or service; (2) installation, operation and maintenance; (3) methods of inspecting the acts of the Licensee; in addition to which the Company, with the Ministers' approval, sets rules regarding the Company's services to subscribers.

The regulations and rules mentioned above regulate the conditions on which the Company may disconnect, discontinue and renew the service at or without the subscriber's request, terminate a service, connect another subscriber to the telephone line of an existing subscriber, and remove telecommunication installations. In addition, the regulations regulate the Company's powers and duties, as well as the rights and obligations of each subscriber. The regulations also regulate the provision of information and entertainment services over the Company's network.

According to the regulations, the Company shall provide its subscribers with the telecommunications services listed in the general license, in a proper and regular manner.

The Company may, with the consent of the Minister, terminate, disconnect or limit the provision of a telecommunications service if the service becomes outdated on technological grounds, or if the service is abused in such a way as to cause tangible financial harm to the public or a part of it, or to the Licensee. Pursuant to the regulations regarding methods of supervision of the acts of a Licensee, the Minister of Communications appointed a manager (an employee of the Ministry) authorized, *inter alia*, to ensure adherence to the provisions of the Communications Law, the regulations and license, for the classes of telecommunications services and conditions thereof, quality of such services and level of maintenance.

In addition, provisions exist regarding reporting, according to which every Licensee must file periodic reports and reports of special events. Rules regarding the Company's services contain provisions relating, *inter alia*, to the issue of bills to subscribers, charging in installments, an appeal committee for complaints regarding charges, and the publication of an entry in the subscriber directory.

The Company acts to locate debtors and to collect debts from its customers. In cases where debts are not paid, legal action is usually taken through external lawyers. In cases such as when it is not financially feasible the debt is written off.

According to the regulations, the Company may disconnect a line if the bill in respect thereof is not paid within 21 days of the payment date prescribed in the bill, and discontinue the service if prior written notice thereof has been given.

On November 22, 2004, draft regulations were submitted for the review of the Company, HOT, and cellular license holders. These were for the establishment of a committee made up of representatives of the public to examine requests for exemption or exception from the provisions stipulated in the regulations or in the general licenses for the provision of services by the Licensee to the entire public. The Company submitted its response to the Ministry and, among other things, requested that an exemption or exception based on the existence of available alternatives in a region for provision of service be subject to the obligation of the Licensee whose request was successful to participate in the costs of financing of a Licensee that provides services in that region. As at the date of publication of this periodic report, to the best of the Company's knowledge, there has been no progress in this regard.

2.16.7 Antitrust laws

A. On June 27, 1995, the Antitrust Commissioner (hereinafter: the "Commissioner") declared the Company to be a monopoly in the following areas: Basic telephone services, provision of communication infrastructure services, unlimited bi-directional international telephone services (including service for incoming calls) and transfer and transmission broadcasting services to the public.

The Commissioner's declaration of the Company as a monopoly constitutes *prima facie* evidence of the terms thereof in any legal proceeding, including criminal

proceedings. Therefore, a plaintiff - being a person or consumer organization - who seeks to sue the Company - or a subsidiary of the Company, in appropriate cases - either by a personal civil action or class action will be excused from proving the fact that the Company is a monopoly, to the extent this proof is relevant for its claim, in reliance on the Commissioner's declaration, and the Company will have to discharge the burden of proof in rebutting the contents of the Commissioner's declaration in this respect.

- B. At the end of 1995, the Company transferred its activity in the field of provision of international telephone services to Bezeq International and as a result, Bezeq International "inherited" the Company's monopolistic position in this market. On April 29, 2001, the Commissioner decided to cancel the declaration of Bezeq International as a monopolist in the field of provision of international telephone services, due to the competition that had emerged in this market.
- C. In light of the changes and developments which have occurred in the communications market overall, and particularly in the field of "basic telephone services", especially in light of the increasing competition in the field of this service compared with the cellular telephone companies, the Company applied to the Commissioner on March 6, 2000, requesting the cancellation of his declaration of the Company as a monopoly in the field of "basic telephone services".

The Company filed an appeal on September 9, 2001 against the Commissioner's decision not to cancel said declaration. Subsequently, the Company consented, at the suggestion of the court (in view of the time elapsed since the appeal, with an accompanying economic opinion, was filed), to withdraw the appeal, and it was struck out on August 2, 2006. In this regard, see also section 2.6.4 above.

- D. On December 11, 2000, the Commissioner declared the Company a monopoly in the field of "telecommunications infrastructure for the provision of high-speed access services via internet service providers". On January 10, 2001, the Company filed an appeal against this declaration.

On November 10, 2004 the Commissioner announced that he had decided to split the existing declaration into two separate declarations:

- (1) Provision of fast access services to subscribers through the access network.
- (2) Provision of fast access services to ISPs through a central public telecommunications network.

As a result and following the changes in the relevant marketplaces since the declaration, Bezeq notified the Court on November 17, 2004 that it wanted to withdraw the aforementioned appeal, and on November 18, 2004, the appeal was expunged.

- E. On August 26, 2004, the Commissioner approved the merger between Pelephone and the company (following the acquisition of Shamrock's share of Pelephone by the Company) under conditions that limit certain joint operations and transfer of commercial information as defined in said conditions.
- F. In May 2006, the Antitrust Authority wrote to the Company regarding complaints from particular communications carriers regarding acts done, prima facie, by the Company to such carriers, and a complaint of one of the carriers received from the Ministry of Communications. According to such carriers, the aforesaid acts amount to abuse of the Company's monopolistic power. The Company was required to provide the Authority and the Ministry with data and response to the questions set out in the letter, and it provided the requested information.
- G. For the search performed at the Company's offices on May 23, 2006, and the interrogation of a number of the Company's employees regarding a suspicion of abuse of monopoly status and/or unreasonable refusal to provide an asset or a service in a monopoly, and for other searches and the interrogation of a number of other employees of the Company (including office-bearers) conducted pursuant to such, see Note 17C to the financial statements of the Company for the period ended December 31, 2006.
- H. For the Commissioner's objection to the merger of the Company and DBS, see section 1.1.5 above.

The Company has adopted an internal compliance policy (hereinafter: the "Policy") containing internal reporting and internal procedures which essentially ensured that the activity of the Company and its employees would be carried out in accordance with the provisions of the Antitrust Law, 5748-1988 (hereinafter: the "Antitrust Law"). The Policy includes a general explanation regarding the Antitrust Law, guidelines for the Company's and its employees' conduct so as not to breach the provisions of the Antitrust Law. Under the Policy, the internal compliance officer issues, from time to time, general and specific directives on various issues (such as pricing, relations with subsidiaries, contacts with customers and the like). The internal compliance officer's directives bind all of the Company's employees and managers.

2.16.8 The Wireless Telegraphy Ordinance

The Telegraphy Ordinance regulates the use of the electromagnetic spectrum, and applies, *inter alia*, to the Company's use of radio frequencies, as part of its infrastructure. The set-up and operation of a system making use of radio frequencies is subject, under the Telegraph Ordinance, to the issue of a license, and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For a number of years, the Government has been dealing with a shortage of radio frequencies for public use in Israel (among other reasons, due to the allocation of a large number of frequencies for security purposes), by limiting the number of licenses granted for the use of frequencies on the one hand, and increasing the fees payable for allocation of a frequency in the lower range, on the other.

The frequency fees were raised in 1999, some by very high rates.

The Company and the Ministry of Communications have a number of differences of opinion regarding fees which the Company claims it does not owe and therefore has not paid. As at the date of this periodic report, the disputed amounts are approximately NIS 42 million.

2.16.9 Proposed legislation regarding termination of contractual relations

In 2005, the Knesset Economics Committee discussed a private member's bill to amend the Consumer Protection Law, which intervenes in the contractual relations between a person dealing in defined deals and the consumer. Under the Bill, a contract will be deemed to provide that it will be rescinded unless the dealer offers the customer to extend the term of the contract and the customer agrees to such.

As drafted in the Bill, this provision will not apply to special offers for up to six months and transactions that will be stipulated in a Schedule to the Law. These transactions have yet to be defined, but the intention, as stated in the discussion of the Economics Committee, is to stipulate in the Schedule those types of transactions which, if rescinded unilaterally, could cause injury to the consumer, such as a basic telephony service.

During the last quarter of 2006, the form of the bill in this regard was once again brought up for discussion in the Economics Committee of the Knesset. Only some of the sections of the bill were voted on. The Company sent its comments to the Committee's legal counsel.

With respect to the hearing for general licensees regarding the intention to regulate a similar issue – the "fixed transaction" issue – via the licenses, see section 2.16.2 above.

2.16.10 The Class Actions Law

On March 12, 2006, a new Class Actions Law was published under which class actions may be filed under a variety of causes of action that are set out in the Schedule to the Law, and under express statutory provisions regarding class actions (detailed provisions in, among others, the Antitrust Law, the Consumer Protection Law, the Banking Law were repealed). Under the Law, the provisions of it shall also apply to applications and actions that are pending in court on the date of publication of the Law. The Law defined and extended the persons who may submit class action applications, and set out the conditions for submission. The Law gives the Court discretion in various matters such as compensation, remedies, substitution of representative plaintiff and restriction on approval of claim against an entity providing an essential service to the public. The Law provides stringent rules regarding the striking out of applications and regarding settlements which require, *inter alia*, the consent of the Court. The Law sets up a fund for the financing of class actions, the role of which is to assist representative plaintiffs in financing applications the submission of which is of public and social importance.

2.16.11 Establishment of communications installations - National Outline Plan 36

- A. The National Outline Plan for Communications, NOP 36, was designed to regulate the deployment and method of establishing communications installations to secure their functioning throughout the entire country, for radio broadcasting and reception, television and wireless communication, while minimizing harm to the environment and the landscape.

B. NOP 36A

Part I of NOP 36 (NOP 36A), dealing with the issue of building permits for small and micro-broadcasting installations, was approved by the Government on May 2, 2002.

A transitional provision contained in NOP 36A stipulates that: (1) a building permit or exemption from a permit that has been issued for a broadcasting installation and not in accordance with the provisions of NOP 36A, will be regarded as irregular use that has been permitted for a period of 18 months commencing from the date of the approval of NOP 36A; If the operator of the installation submits to the institution that approved the erection of the installation, within said period, a permit from the Commissioner for Radiation regarding compliance with the safety restrictions stipulated in the Plan, the permit or the exemption from the permit will be regarded as permitted irregular use. Otherwise, the permit or exemption will expire. (2) A permit issued within two years of the date NOP 36A was approved for broadcasting installations erected prior to January 1, 1989, shall not be deemed as conflicting with NOP 36A, provided it meets the safety restrictions stipulated in the Plan.

As of the date of this periodic report, the Company has submitted to the relevant licensing authorities a permit from the Commissioner on Radiation from all of the 74 small broadcasting installations erected under a permit issued prior to the approval of NOP 36A and building permits have been issued for most of the small broadcasting installations in accordance with NOP 36A. The Company is dealing with obtaining the permits from the relevant licensing authorities for the remaining 14 small broadcasting installations. Due to intensive activities being done at the Company regarding the obtaining of permits, and due to the termination of operation of certain installations, the number and class of sites change from time to time.

Given the provisions of the Planning and Building Law, 5725-1965 and the provisions of the Communications Law, the Company believes that the obligation to be issued building permits for micro-broadcasting installations, which are "wireless access facilities" do not apply to it under said laws.

C. NOP 36B

Part B of the Plan (NOP 36B) applies to all types of broadcasting installations, except for those included under NOP 36A. The licensing process proposed under NOP 36B requires the preparation of a detailed plan (except in unusual cases) and the receipt of the necessary approvals which are also required under NOP 36A.

NOP 36B proposes transitional provisions under which: (1) a building permit issued for a broadcasting installation according to a previous plan which does not comply with the provisions of the NOP 36B, shall be regarded as irregular use that was permitted for a period of 24 months from the date of the approval of the Plan. If the operator of the installation submits to the institution that approved the erection of the installation, a permit from the Commissioner on Radiation of compliance with the safety restrictions prescribed in the Plan, within said period, the permit will be regarded as being in compliance with the provisions of NOP 36B. Otherwise the building permit shall expire. (2) A permit may be granted for broadcasting installations erected prior to the approval of the NOP 36B at a broadcasting site which existed prior to January 31, 1984, even if the installations do not comply with the provisions of the NOP 36B, provided they meet the safety restrictions specified in NOP 36B.

The Company's broadcasting installations included in NOP 36B were for the most part built many years ago, some by State authorities.

NOP 36B further proposes to include a provision according to which a building permit will not be granted according to Chapters C and D of the Plan, unless the applicant for the permit has submitted a letter of indemnity for compensation under Section 197 of

the Planning and Building Law, should a judgment go against the local committee. The Company has submitted its objection to the inclusion of said provision in NOP 36B.

The Company is working with the Ministry of the Interior and the Ministry of the Environment with respect to the entry into force of NOP 36B which deals with building permits for the large broadcast installations.

D. General

For Amendment No. 75 of the Planning and Building Law, 5725-1965, which includes a requirement to deposit deeds of indemnity for cellular communications broadcast installations, and the decision of the National Building and Planning Council of January 3, 2006 given in respect thereto, see Section 2.15.2 above, and sections 3.18.1.3 and 3.18.3.3 below.

The decision of the National Planning and Building Council of January 3, 2006 also provided that a committee of drafters of the NOP, in a new composition which has been prescribed, would examine the recommendations of the committee of directors general of the relevant government Ministries, regarding the deployment of cellular broadcasting installations under NOP 36A, with reference to the issue of indemnity, would recommend the making of amendments to the issue of the deed of indemnity under NOP 36A, and the decision that it comes to regarding indemnity would apply, *mutatis mutandis*, to NOP 36B as well.

E. With respect to radiation permits for broadcasting installations, see section 2.15 above.

2.16.12 Bill to amend Section 13 of the Communications Law

On November 22, 2005, the Ministry of Communications sent general licenses, for their comments, a bill to amend Section 13 to the effect that the prisons service be included as part of the security forces, and to add a Section 13A to the Communications Law regarding the power of the Minister of Communications to give instructions to a licensee during emergencies. This comes after a discussion in the Economics Committee of the Knesset, held after the Bill had passed first reading. On November 24, 2005, the Company provided the Minister of Communications with its comments, to the effect, *inter alia*, that extreme situations and other situations included in the definition of "emergency" should be distinguished, that the licensees should be heard and that the provisions regarding payments as a result of performance of the provisions should be amended.

On September 11, 2006, another amended form of the bill was sent to the general licensees, in view of a discussion that was subsequently held in the Economics Committee of the Knesset. A provision was added in the amendment, granting jurisdiction to the Ministry of Communications to give instructions to licensees in the event of a significant malfunction or stoppage in the provision of a telecommunications service and in the provision of broadcasting, other than under emergency circumstances. At the above discussion in the Economics Committee of the Knesset, it was argued that this provision amounts to a "new topic". Therefore, sections of the bill were not discussed in the Economics Committee. The Company's position paper on the proposed addition makes it clear that the provision that was added is unreasonable, and that it is unjustified in general, and in particular in the context of this statutory amendment, because extending the application of provisions dealing with emergencies to matters that relate to relationships between carriers is not proportionate, and does not comply with the Basic Laws test. The bill that included the new provision was brought up for discussion, was discussed, and votes were held on the discussion in the Economics Committee of the Knesset.

2.16.13 Restrictions and supervision of the Company's operations regarding the Government decision on proposals to amend the Communications Law under the "Arrangements Law"

In September 2006, the Government decided to approve the decision of the Ministerial Committee on Socio-Economic Affairs to amend the Communications Law with respect to the imposition of monetary sanctions on a licensee, *inter alia*, such that the sum of the monetary sanction which may be imposed for breach of a provision of the license or of certain provisions of the Communications Law, will be increased with respect to a licensee whose revenues during the financial year preceding the breach are greater than NIS 100 million, from twenty-five times the amount of the fine set out in section 61(a)(1) of the Penal Law, 5737-1977 to seven times the amount of the fine set out in section 61(a)(4) of the

Penal Law (approximately NIS 1,400,000), plus 0.25% of the revenues of the licensee in the financial year preceding the date of the breach (meaning, for the Company, approximately NIS 12,000,000 in 2005 terms, in addition to the above sum). The Director General of the Ministry shall be entitled to reduce the rate of the sanction in circumstances where the licensee or the permit holder cooperates with the Director General in disclosing all information and/or takes steps to reduce or terminate the breach up to a deduction of 15% for each cause of action.

Likewise, the Government decided to amend section 5 of the Communications Law and add a provision whereby if the Minister is of the opinion that such is necessary in order to set-up infrastructure for radio broadcasts using the digital method, under the Second Radio and Television Authority Law, 5750-1990, and there being no other reasonable alternative to setting up such infrastructure, the Minister may give an instruction to a general licensee that use will be made of its installations in order to set up such infrastructure, in consideration for such payment as may be prescribed.

The Company's position is that in addition to arguments relating to the main body of these proposals, the Arrangements Law cannot be used as a half-way house for these kinds of amendments, since they are provisions with serious and substantial consequences, including penal provisions and provisions that harm the Company's property.

On January 11, 2007, an amendment to the Communications Law was published under the Arrangements Law which contained provisions regarding the expansion of the monetary sanctions, *inter alia*. Section 5 has been split from the Bill and is not included in the form of the amendment that was passed.

2.17 Substantial agreements

The following is a summarized description of the substantial agreements that are not part of the Company's ordinary course of business, and that were signed and/or were in force during the period of this periodic report:

2.17.1 Debentures

A. Deed of trust for debentures (series 4) dated May 24, 2004

A deed of trust for a series of 1,200,000,000 debentures of NIS 1 par value each, repayable in four equal annual installments on June 1 of each of the years 2008 to 2011, bearing annual interest of 4.8%, linked (principal and interest) to the CPI for April 2004. Of these, 800,000,000 Debentures were to the public by prospectus (hereinafter: the "Prospectus") on May 24, 2004 and 400,000,000 were purchased by a wholly owned and controlled subsidiary of the Company, Bezeq Zahav (Holdings) Ltd. (hereinafter: "Bezeq Zahav Holdings") immediately prior to the Prospectus and were listed for trade according to the Prospectus.

B. Deed of trust for debentures (series 5) dated May 24, 2004 and an addendum to this deed dated December 6, 2004

A deed of trust for a series of 600,000,000 debentures of NIS 1 par value each, repayable in six equal annual installments on June 1 of each of the years 2011 to 2016, bearing annual interest of 5.3%, linked (principal and interest) to the CPI for April 2004. The debentures were issued prior to the Prospectus to institutional investors and to Bezeq Zahav Holdings and listed for trade according to the Prospectus.

An addendum to the deed of trust for the debentures in this series relates to the issue of an additional 1,500,000,000 debentures which were issued by the Company to Bezeq Zahav Holdings under the same conditions and listed for trade on the stock exchange (subject to lock-up restrictions).

On March 30, 2005, another addendum to this deed of trust was signed between the Company and the Bank Mizrahi Trust Company Ltd. for the issue of NIS 286,967,000 par value debentures in the same series.

C. Series of agreements regarding raising capital through the issue of debentures (Eurobonds) on the Luxembourg Stock Exchange

A series of agreements (including debentures) related to the issue of Company debentures on August 8, 2000 on the Luxembourg Stock Exchange – a series of 300 million euros par value 7 year debentures (as part of a total of up to 750 million euros). The debentures bear interest of 6.5% per annum. The interest is paid in annual installments, on August 8 each year, from August 8, 2001 through August 8, 2007.

2.17.2 Real Estate

- A. Asset transfer agreement between the Company and the State dated January 31, 1984

An agreement between the State and the Company, under which the Company was conferred the State's rights in assets which the Ministry of Communications used for providing telecommunication services, and the Company assumes the rights of the State with respect to those assets and the obligations and liabilities with respect to these rights immediately prior to implementation of the Agreement. Moreover, under that Agreement, the State's rights, powers, obligations and duties according to the agreements, contracts and transactions that were in force with respect to telecommunications services immediately prior to implementation of the Agreement, were transferred to the Company.

- B. Settlement agreement between the Company, State and Israel Lands Administration regarding rights related to land, dated May 15, 2003

See Section 2.7.4C above.

- C. Agreement between the Company and the Israel Postal Authority

An agreement dated June 30, 2004 between the Company and the Israel Postal Authority to define and arrange the rights of the Company and the Postal Authority to their joint assets. The agreement listed the joint assets and defined the share each party has in them. It was determined that each of the parties shall have exclusive rights to their share, except with regard to rights in joint assets, building rights or rights that have been explicitly clarified elsewhere. With regard to a number of additional assets, the party with exclusive rights to them, in whole, will be one party that was so determined.

2.17.3 Various agreements with DBS and its other shareholders

- A. On December 4, 1998, the founders of DBS – the Company, Eurocom Communications Ltd., Lidan Business Enterprise Ltd. and Gilat Communications Ltd., entered into a Founders Agreement, which regulates the establishment, management and relationship between the shareholders of DBS.
- B. An agreement dated December 30, 1998 between the shareholders of DBS, stipulated the establishment of an executive committee and its authorities.
- C. In November 2001, an agreement was signed between the shareholders (except for Gilat) and DBS, amending the dilution formula stipulated in the Founders Agreement and determined that the holdings of the shareholders be adjusted to their proportionate holdings in DBS, such that for the purpose of dilution, the investments (effected by way of shareholders loans) would bear CPI linkage differentials and annual compound interest at a rate of 5.5% per annum from the date of incorporation of DBS.
- D. An agreement dated December 30, 2002 between DBS shareholders and DBS determines preference for shareholder loans given as of July 10, 2002 over the loans made prior to that date, and that these loans would bear CPI linkage differentials and annual linked compound interest at a rate of 5.5%, and an amendment to the agreement dated August 6, 2003 which stipulated an interest rate of 11% for new loans granted as of April 27, 2003.

2.17.4 Labor agreements

- A. A comprehensive pension agreement was executed on September 21, 1989 between the Company, the Histadrut and the joint representation of the workers' committees and Makefet Fund – Center for Pensions and Remuneration Cooperative Society Ltd.

The agreement provided a full and autonomous arrangement regarding the pension insurance of Company employees. The agreement applies to all transferred

employees (who were transferred from the Ministry of Communications to the Company), to all of the members of the cumulative pension fund employed by the Company on the date of execution of the pension agreement and to all of the permanent and temporary employees of the Company, with the exception of special employee groups (students, employees under personal contracts or employees under some other alternative arrangement).

- B. Special collective bargaining agreement for early retirement, dated November 23, 1997 as amended and extended on September 4, 2000, March 18, 2004, April 17, 2005 and June 28, 2005 between the Company, the Histadrut and the Workers' Organization

For information on this, and regarding early retirement, see Note 16 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

- C. Agreement to anchor rights, dated September 4, 2000 between the Company, the Histadrut and the Workers Organization

A special collective bargaining agreement executed between the Company, the Histadrut and the Workers Committee, *inter alia* regarding anchoring the rights of the transferred employees. This agreement was intended to anchor the rights of the transferred employees to the pension rights to which they were entitled by virtue of their being former public servants, under the Company's pension agreement, adopted by the Company under its pension agreement. According to this agreement, these rights became "personal rights" which could not be cancelled, other than by waiver of personal rights under law (i.e., by personal waiver by the employee himself or herself).

In this regard see also section 2.9.5 above.

- D. "Generation 2000" agreement, executed on January 11, 2001 between the Company, the Histadrut and the Workers Organization

Following an amendment in July 2000 to the Employment of Employees by Human Resources Contractors (Amendment) Law, 5760-2000, a special collective bargaining agreement was signed between the Company, the Histadrut and the Workers Committee on January 11, 2001 to recruit new employees and stipulate their salary conditions. The agreement applies to new employees and to employees who were previously employed at the Company via human resources companies, in positions listed in the appendix to the agreement (customer service representatives at call centers, administrative workers, typists, warehouse employees, secretaries, mail sorters and distributors etc., administrative employees such as porters, drivers and forklift operators, and others).

Employees are to be employed under this agreement for a period of no more than 6 years, with an option to extend the agreement for a period of two further years.

- E. Contract dated April 17, 2005 with substitute body replacing the Makefet Fund with respect to early retirement arrangements for Company employees

On April 17, 2005 a special collective agreement was signed between the Company, the Workers Organization and the Histadrut, concerning an arrangement with an alternative entity to the Makefet Fund for everything relating to early retirement arrangements for Company employees.

In addition, on June 28, 2005, an agreement was entered into between Harel Insurance Company Ltd. ("Harel") and the Company. The contract regulates payment of pensions for early retirement and provisions for old-age and survivor pensions deriving from legislative amendments under the Israeli Economy (Recovery Program) Law for employees who retired from the Company from the end of 2003 / beginning of 2004 and/or who will retire from the Company in accordance with the special collective agreement for retirement of September 2000 as amended on March 18, 2004 and on April 17, 2005. Following execution of the agreement with Harel, the special collective agreement between the Company, employee representatives and the General Trade Union as aforesaid was amended on the same date (June 28, 2005).

In this regard, see also Note 16(g) to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

F. New special collective agreement dated December 5, 2006

A collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company (see section 2.9.1 above).

Under the agreement, all agreements, arrangements and procedures existing in the Company prior to execution of the agreement, including the mechanism of linkage of salaries to the public sector, shall continue to apply to permanent, senior employees of the Company only, to whom the agreement applies, subject to amendments made expressly in the Agreement. Existing and new temporary employees shall be employed on the basis of monthly / hourly salary agreements that are based on a market salary model according to their businesses, with a high level of administrative flexibility.

The agreement also provides that in 2006-2008, 975 permanent employees shall retire from the Company under early pension schemes or increased severance pay schemes. The Company shall also be entitled, at its discretion, to terminate the employment of a further 1225 permanent employees (245 permanent employees during any one or more of the years 2009-2013). The retirement conditions to be offered to the retirees shall be identical, for the most part, to the retirement conditions employed at the Company at present.

The agreement shall be valid from the date of execution of it until December 31, 2011. The Company has an option to extend the agreement for two more years until December 31, 2013. The retirement chapter of the Agreement shall, in any event, expire on December 31, 2013.

2.17.5 Management Agreement

On March 23, 2006, the general meeting of the shareholders of the Company approved entry by the Company into an agreement with a company which is to be owned and controlled by the shareholders of Ap. Sab. Ar. under which the Company shall be given ongoing management and consultancy services, including via directors who may act from time to time in the Company and/or its subsidiaries, all in return for USD 1.2 million each year. The term of the contract is from October 11, 2005 (the date of completion of acquisition of 30% of the shares of the Company by Ap. Sab. Ar.) and until December 31, 2008, unless one of the parties gives notice to the other of its desire to terminate the contract by way of prior notice of three months in advance.

2.18 Legal proceedings

For information on legal proceedings see Notes 15, 16 and 17 to the financial statements for the year ending December 31, 2006, included in this periodic report, and sections 1.1.5, 2.6.1 and 2.6.6 above.

2.19 Goals and Business Strategy

2.19.1 Forward-looking information

It is only natural that a review of Company strategy involves expectations regarding future developments with respect to customer behavior and needs, adoption rate of new services, technological advances, regulatory policy, marketing strategy employed by competitors, and the effectiveness of the Company's marketing strategy.

The Company's strategy and the business objectives derived from it are based on internal research, secondary information sources and primarily on reports issued by research groups, publications regarding activities by similar communications providers in Israel and around the world, and the work of consultants that have assisted the Company.

However, there is no certainty that the strategy and main activities described below will actually be realized or realized in the manner described below. The circumstances that may lead to non-implementation of the strategy or even its failure relate to frequent technological changes, regulatory constraints, design of a sustainable business model for new services the Company plans on providing and implementation of a preferable

marketing strategy by competitors. Furthermore, a change in the ownership of the Company may also lead to changes in its strategy and business objectives.

2.19.2 Summary of strategy and future plans

At the Group level

As at the date of publication of this periodic report, the Company is acting, upon consultation with an international consultancy firm, to formulate its strategy as a communications group for the coming years.

At the Company Level

The Company is operating to implement a strategy of going from a company that provides infrastructure only, to a company that provisions a variety of products and services that are tailored for customers' needs.

Vision and objectives

The Company has set a goal of reinforcing its position as the leading telecommunications company in Israel, while providing end-to-end solutions to business customers and creating a user experience for private customers, and providing quality service and business excellence.

In order to achieve this goal, the Company faces a number of challenges:

- A. Maintaining its leading position in an ever-more competitive environment (leadership in service and strengthening values – product innovation, reliability, closeness to customer);
- B. Reducing the decline in revenues from core services;
- C. Generating new sources of revenue;
- D. Adapting the organization to the competitive environment and operational excellence.

To implement the strategy and achieve said goals and objectives, the Company uses and will continue to use the following:

Business customers

- A. Offering variety in its basket of products and services;
- B. Providing a comprehensive solution based on the needs of the customer, while using a policy that dictates a commitment to quality and availability of service;
- C. Encouraging customer migration from basic services for managed solutions to organizational and inter-organizational connectivity;
- D. Offering a variety of value-added services.

Private customers

- A. Continuing to penetrate broadband and improving infrastructures to increase bandwidth;
- B. Providing differential pricing tracks;
- C. Strengthening the positioning of the Company's telephony services, while focusing on advanced applications and penetration of advanced terminal equipment.

Network

In order to attain its strategic goals, the Company is acting with respect to improvement of its network and tailoring it to its commercial targets, as follows:

- A. The Company is examining the issue of deployment of a new-generation switching network (NGN), which will allow it to launch new services with a shorter time to market, simplify the structure of the network, reduce maintenance and operation costs, and leverage real estate potential (see also section 2.6.7 above).
- B. The Company is examining a policy that will allow a significant increase in bandwidth to customers by bringing the fiber closer to the customer home and integrating new technologies.

Organizational restructuring and implementation at the Company

For the change in the Company's organizational structure, implementation and integration of such, see sections 2.6.7(i) and 2.9.1 above.

2.19.3 Development trends in Company activities

- A. The Company is working to increase bandwidth and data transmission rates for the services it provides to its customers. The Company takes marketing initiatives which are designed to switch its customers to its high speed internet service. Furthermore, the Company offers its business customers fast transmission and data communications services over a variety of protocols.
- B. The Company is working towards integrating itself in IP (Internet Protocol) applications. It has therefore set up an IP network to serve as a platform for the services it currently provides and the additional services it plans to offer in the future.
- C. The Company is studying the technological feasibility and the business model for distributing digital content (either owned by it or through license by third parties) over the Company's network and infrastructures.
- D. The Company launched fixed-line and wireless home network services that enable multiple computers to connect simultaneously to the internet from a number of computers.
- E. The Company launched a brand of telephones that operate on new technologies and which are equipped with advanced software. The Company is integrating the advanced phones as part of its marketing initiatives and the special offers it makes from time to time.
- F. The Company is examining how to be part of provision of FMC (Fixed Mobile Convergence) services.
- G. The Company has launched a variety of billing tracks for telephony services along with its basic tariff structure to increase the use of its services.

2.19.4 Main projects being planned or currently being implemented

The main projects currently being implemented by the Company include improving IPVPN services and those derived from it within the business sector, as well as upgrading the speed of ADSL-based high speed internet service to private customers. Additional projects include IP Centrex service as a platform for the provision of private virtual exchanges on the Company's private network (see section 2.2.5(d) above). The Company has also commenced a project setting up a data center service. This project includes setting up a high-standard computing installation which will enable business customers to receive hosting services, computer and server rooms in the installation built especially for this purpose in order to expand the server rooms at a business, or as a back-up for communications infrastructure.

Furthermore, the Company is studying the significance of entering the FMC arena, by marketing dual phones that work both on the Company's network within the home or office and on cellular networks outside the home. From a technological perspective, the Company is preparing to conduct a field trial for customer migration in a number of services areas to a uniform IP-based network.

2.20 Events or Issues not within the Ordinary Course of Business

- A. On December 5, 2006, a new special collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company. For this, see sections 2.9 and 2.17.4 above.
- B. On March 29, 2007, the board of directors of the Company resolved to appoint Adv. Dr. Yoram Danziger to the post of external examiner regarding matters arising out of immediate reports given by the Company on March 20, 2007 regarding the approval of an option plan for employees and managers, an immediate report given by the Company on March 26, 2007 regarding grants to office bearers and an immediate report given by the Company on March 26, 2007 regarding presentation anew, in accordance with the provisions of the letters from the Securities Authority to the Company dated March 25, 2007 and March 28, 2007. The external

examiner, who shall commence work on April 1, 2007, shall be required to submit his interim findings to the board of directors of the Company and to the Securities Authority no later than April 12, 2007, and his final findings by April 26, 2007.

For the removal of any suspicion, and if only for the sake of appearances, with respect to the external examiner's full freedom of operation and access to all material at the Company as he may see fit, the CEO of the Company, Mr. Yacov Gelbard, asked for the consent of the board of directors to permitting him to take leave of absence until the date of submission of the interim findings by the examiner, as set out above. The board of directors of the Company accepted Mr. Gelbard's request and resolved that during the period of Mr. Gelbard's absence, Mr. Yitzhak (Ika) Abarbanel, currently the deputy CEO of the Company, will act in place of Mr. Gelbard, as substitute CEO of the Company.

2.21 Risk factors

A. Increasing competition

Competition in fixed-line domestic communications in specific sectors (such as data transmission and data communications) is already underway, and in the area of telephony – has also begun. Furthermore, the Company views the cellular telephony market as a market which, to a large extent, is an alternative to the fixed-line domestic telephony market.

The organizations currently competing against the Company or which may compete against it in the future are generally subject to government regulation that is not as strict as that with which the Company must contend. They benefit from far more business flexibility, including the ability to partner with subsidiaries and affiliates and market joint service packages with them.

The possibility of providing telephony services over the Company's and HOT's broadband infrastructure (VOB) and number portability could also contribute to increased competition.

B. Government supervision and regulation

The Company is subject to government supervision and regulation that, among other things, relate to licensing for activity, determining permitted areas of activity, operation, competition, payment of royalties, obligation to provide universal service, determining tariffs, ability to hold its shares, relationships between the Company and its subsidiaries and prohibition to terminate or restrict its services (which may force the Company to provide services even when not economically feasible or when it goes against its interests). Said supervision and regulation at times lead to State intervention, which the Company believes adversely affects its business operations.

C. Regulation of tariffs and the phenomenon of cross-subsidy

The Company's tariffs for services are subject to State regulation. These tariffs are stipulated in regulations, and regulations also stipulate a formula for linking them to the changes in the Consumer Price Index, less an amount for depreciation. The practical implication of this mechanism is erosion (in real terms) of the Company's tariffs. Some of the Company's tariffs are subject to the Supervision of Prices for Commodities and Services Law. Furthermore, the bureaucracy involved in setting "tariff baskets" for the sale of service packages by the Company delays the time to market of the tariff baskets, affecting the Company's ability to compete.

In recent years the tariff committees and regulatory agencies have worked to reduce the phenomenon of cross-subsidies in the Company's tariffs, but cross-subsidies still exist between the tariffs of various services offered by the Company, some of which are provided at a lower tariff than the cost of providing the service, and others are provided at a higher tariff. The Company cannot cancel or reduce cross-subsidy without the approval of the regulatory agencies.

D. Difficulties in labor relations and human resources

As a part of the preparations to cope with the increasing competition in the field, the Company must continue to formulate additional plans for organizational changes and make a further reduction in the number of personnel. The implementation of these plans has involved and is expected to involve, coordination with the employees and substantial costs, including the cost of compensation for early retirement, over and above the costs which are stipulated in existing agreements. The implementation processes of these plans have in the past caused and may cause in the future unrest in labor relations and hurt the Company's regular business.

Labor relations at the Company have, over the years, seen ups and downs, but in management's opinion, following execution of the new collective agreement and the change in the organizational structure, labor relations are now expected to be quieter and more stable than in the past.

E. Restrictions upon entry into new services

The timetables stipulated in the Company's general license for approval of the services, the nature of the changes required by the Ministry of Communications for the service portfolio submitted and delay in the approval of the services by the Ministry do not allow the Company to increase the variety of its services at the pace it believes is required to respond to market-driven demand, and at the time required by the Company's customers.

F. Restrictions on relations between the Company and companies in the Bezeq Group

The Company's general license obligates it to ensure that its relationship with its principal subsidiaries in the Bezeq Group does not cause them to be preferred over their competitors. Under the general license, separation is required between the respective managements of the Company and said companies, and separation is also required in the financial and marketing systems, as well as assets and employees, which causes high administration overheads. The Company is also not allowed, at this stage, to offer joint service bundles with the aforesaid companies. In light of the development of communications groups in the field which are not subject to such restrictions on joint operations, the extent to which this risk factor might affect the Company's operations has increased as the competition has developed.

G. Legal proceedings

The Company is a party to legal proceedings, including class-action claims, which may cause it to have to pay significant sums, most of which cannot be estimated. Therefore provisions have not been made in the Company's financial statements and in those of companies in the Group.

Class-action claims can reach large amounts, as virtually all residents of the country are consumers of the Company's services, and a claim that relates to minor injury to a single consumer may become a significant case for the Company if it is recognized as a class action that applies to all consumers or a significant portion of consumers. Additionally, as the Company provides communications infrastructures as well as billing and collection services to other Licensees, parties initiating legal action against said Licensees in other class action cases may even try to involve Company as a party to these proceedings (for the legislative proceedings regarding class actions see section 2.16.10 above).

For a description of the legal proceedings, see section 2.18 above, which refers, inter alia, to Note 17 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

H. Exposure to exchange rate fluctuations and inflation

The Company assesses exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities based on the type of linkage. Therefore the Company is exposed to changes in exchange rates against the shekel. However, due to the currency hedging policy implemented by the Company, exposure has until now been low. The Company has taken and continues to take protective actions against most exposure from exchange rate fluctuations. That said, the Company has not fully neutralized its exposure to exchange rate fluctuations, by converting its liabilities denominated in foreign currency and/or linked to the consumer price index, to shekel-denominated liabilities.

I. Electromagnetic radiation and licensing of broadcast installations

The issue of electromagnetic radiation emitted from broadcast facilities is regulated mainly in the Non-Ionized Radiation Law, 5766-2006, and in the Pharmacists Regulations, and the issue of licensing is governed by NOP 36 (see sections 2.15 and 2.16).

The Company is working to obtain permits to build and operate its various broadcasting installation, however, the difficulties it faces in this activity, including difficulties related to the change in policy maintained by the various relevant organizations, may negatively impact on the infrastructure of said installations and on the regularity of provision of services using them.

The Company's third-party liability policy does not currently cover electromagnetic radiation.

J. Frequent Technological Changes

The communications field is characterized by frequent technological changes and a shortening of the economic life-span of new technologies. These trends mean a lowering of entry barriers for new competitors, an increase in depreciation rates and in certain cases, redundancy of technology and networks owned by the Company, the cost of investment in which may still be recorded on its balance sheets.

Risk Factor Summary Table

	Effect of Risk Factor on Company Activity		
	Large effect	Medium effect	Small effect
Macro risks			
Exposure to exchange rate fluctuations and inflation			X
Sector Risks			
Increasing competition	X		
Government supervision and regulation	X		
Tariff supervision	X		
Electromagnetic radiation / licensing of broadcast installations		X	
Frequent technological changes		X	
Special risks faced by the company			
Exposure in legal proceedings		X	
Difficulties in labor relations		X	
Restrictions on relations between the Company and companies in the Bezeq Group	X		
Restrictions on offering new services (and entry into joint ventures)		X	

3. Mobile Radio Telephone – Pelephone Communications Ltd. “Pelephone”

3.1 General Information on Area of Operations

3.1.1 Pelephone’s field of activity

Four companies operate in Israel's cellular communications market. Activity in the mobile radiotelephone sector (“MRT” or “Cellular Communications”) began with the incorporation of Pelephone in 1985. Pelephone deals in the provision of cellular communications services, and sale and repair of terminal equipment. Pelephone’s revenues include, inter alia, the charging for MRT communications customers (payments for call minutes, regular subscriptions, added value services and migration services, payment for the sale of terminal equipment and in respect of terminal equipment services) and revenues from other communications providers for interconnect (see sub-paragraph 3.2 below).

As of August 2004, Pelephone is wholly owned by Bezeq.

3.1.2 Legislative and secondary legislation restrictions applicable to Pelephone

3.1.2.1 General license

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Services, which is valid until 2022 (hereafter: “the license”). The license prescribes conditions and rules that apply to Pelephone’s operations, and the competent authorities may amend the licensing conditions subject to the law.

3.1.2.2 Tariff control

The tariffs that Pelephone is permitted to collect from its subscribers are regulated by its license with the exception of the call completion and SMS tariffs, which are regulated under regulations as of October 2000. In December 2004, the Telecommunications (Telecommunications and Broadcasts) (Payments for Interconnect) Regulations, 5760-2000, were amended in such a way as to reduce tariffs for interconnect to the MRT network regarding call completion, transmission of SMS messages and to modify the method of calculating the duration of chargeable time beginning in 2009 (see sub-paragraph 3.18.2).

3.1.2.3 Royalties

Under its license and under the Telecommunications (Royalties) Regulations 5761-2001, Pelephone pays the State of Israel royalties out of its revenues which bear royalties due to the provision of telecommunications services (see section 3.18.3.2 below).

3.1.2.4 Environmental matters

The laying of the wireless infrastructure including cellular communications is subject to prior approvals from the Ministry of the Environment. The Ministry also establishes a standard for periodical radiation tests (see Clause 3.17).

3.1.3 Changes in the volume of activity and profitability in the field

The following are financial and quantitative data regarding Pelephone scope of operations and profits for 2005-2006:

	2006	2005
Revenues (NIS millions)	4,478	4,428
Operating profit (EBIT) (NIS millions)	700	591
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	1,171	1,021
Number of subscribers at end of period ¹⁶ (in thousands)	2,427	2,287
Average minutes of use (MOU) ¹⁷ per subscriber per month	349	338
Average monthly revenue per subscriber (NIS) (ARPU) ¹⁸	138	138

3.1.4 Market development and changes in customer attributes

In recent years, the cellular market has been characterized by lower growth rates than in the past due to saturation of penetration rates. The competition's focus on increasing growth rates encourages the companies in the field to increase their segmentation and to make special offers to various target groups, providing specific responses to their needs.

3.1.5 Technological changes being such as to affect the company's field of activity

3.1.5.1 In the cellular industry, there are two main technological tracks:

- A. The CDMA track, which developed in the 2.5 generation to 1X and in third generation to EVDO (hereinafter: "CDMA Technology") – Pelephone's network operations using this technology.
- B. The GSM track, which developed in the 2.5 generation to GPRS and in the third generation to UMTS / HSDPA, and in the 3.5 generation to HSUPA (hereinafter: "UMTS Technology") – the networks of Pelephone's principal competitors in Israel use this technology.

3.1.5.2 In 2004 Pelephone launched 3rd generation services in Central Israel by means of CDMA 2000 EVDO which connects up to CDMA 2000 1XRTT technology that is deployed throughout the country. The EVDO network was deployed in urban areas during 2004-2006 (for details see section 3.9 below). 3rd generation services to enable transfer of data, including video, in larger files and enables Pelephone to offer its customers a wide range of added value services (for details see section 3.2.1 below).

3.1.5.3 Pelephone has the right to receive allocation of frequencies in ranges of 2000MHZ that can be used by Pelephone for UMTS technology. The UMTS technology, if applied, will enable Pelephone to provide services requiring the rapid transmission of information, may solve the problem of wireless disturbances (see sub-paragraph 3.25.2.5) and will enable use of standard terminal equipment supporting UMTS technology which will permit the reduction of prices of terminal equipment and extension of roaming services (see section 3.2.1). At the end of 2006, the board of directors of Pelephone resolved to allow management of Pelephone to take steps to examine the setting up of another network using UMTS technology, including support of HSDPA / HSUPA technology. In addition, initial preparations and investments for setting up this network have been approved. At the beginning of March 2007, the RFP to set up the new network was distributed to infrastructure suppliers. Setting up of this network is subject to the approval of Pelephone's authorized bodies.

¹⁶ Subscriber data relate to active subscribers having received or made at least one call in the past six months.

¹⁷ MOU (Minutes Of Use) – average monthly minute use per subscriber. This index is calculated in accordance with an annual average of the sum total of outgoing and incoming minutes each month, divided by the average number of subscribers during that month.

¹⁸ ARPU (Average Revenue Per User). This index is calculated by averaging the division of total revenue from cellular services and repairs each month by the average number of subscribers in that month.

3.1.6 Critical success factors and the changes commencing therein

In the estimation of Pelephone, the following constitute the principal factors of success in its field of activity:

- National deployment of a high-quality, advanced MRT network, ongoing maintenance of the network at a high level and significant investments, on an ongoing basis, in cellular infrastructure, for the purpose of improving high-quality coverage around the country, which is a basic condition for the provision of Pelephone's services, and in order to provide customers with the most advanced services, via the most advanced technological infrastructure.
- Provision of high-quality call services and advanced added value services.
- National deployment of service and sale centers which enable high quality customer support and service which allows the company to successfully deal with a competitive market.
- Professional, high-quality, human resources.
- Marketing strategy for grounding and reinforcing the brand name.

3.1.7 Principal entry and exit barriers

The principal barriers to entry to the area of operations are:

- the need for a MRT license, the allocation of frequencies, and operations being subject to the regulatory supervision that applies to the market (see section 3.18 below).
- the need for significant financial resources for making serious investments in infrastructure, which are affected by frequent technological changes, and the importance of providing a response to the needs of the market.
- The difficulty involved in setting up radio sites due to regulatory restrictions and public objections.

It is important to note that the investment barriers do not apply to any potential virtual carrier (see section 3.7.2 below).

The principal barriers to exit from the area of operations are:

- Long-term agreements with infrastructure suppliers and property owners with whom Pelephone has entered into lease agreements.
- Large investments which require long periods to recoup investments.
- The obligation to provide services to customers in accordance with conditions prescribed in the license.

3.1.8 Substitutes for Pelephone products

Domestic fixed-line telephone services provided by the domestic operator companies may constitute a substitute for some of the services provided by Pelephone.

Telephony services based on VOIP/VOB technology might constitute a substitute for cellular services in areas where the local wireless networks have coverage.

3.1.9 Structure of competition in the sector and changes therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of Bezeq's license and on its behalf¹⁹). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (hereafter: "**the second operator**" or "**Cellcom**"). In February 1998, a third operator was selected by invitation to tender – namely Partner Communications Ltd. (hereafter: "the third operator" or "Partner"). As of February 2001, MIRS Communications Ltd., (hereafter: "**MIRS**") has been operating as an additional cellular operator. After the entry of the second operator, and later, the third operator, into the cellular market, fierce competition developed among the carriers (primarily between the three main carriers). This competition resulted in

¹⁹ Bezeq's license was in fact amended in April 1994, when it was prohibited from supplying a cellular service. A general license was in fact granted to Pelephone in February 1996, which had retroactive application back to 1994.

market saturation expressed in the diminution of the number of subscribers joining the company, an increase in the transfer of customers between the cellular companies and an erosion of the real prices collected by Pelephone from its customers for services rendered by it (see section 3.7 below).

3.2 Products and Services

3.2.1 Services

Pelephone provides its subscribers with comprehensive services of voice transmission, data communications and advanced multimedia services as follows:

Basic telephone services (VOICE) – Pelephone’s service package includes basic voice services and also auxiliary services such as – call waiting, follow-me, voice mailbox, voice conference call and caller ID.

Advanced services (hereinafter: “added value services”) - the subscriber may purchase added value services such as text message services and information services using SMS, multimedia MMS messages, voice information services using special-purpose asterisks, information and entertainment services via the Internet portal and advanced content services such as JAVA games, network games and video games. Among other things, subscribers may choose animation items or different ring-tones from Pelephone’s internet portal, and may download them to their handsets. Also, subscribers may receive services connected to their electronic diaries (Outlook services) enabling subscribers to obtain SMS messages regarding the arrival of e-mail messages, and to read and reply to them, all through their handsets. Moreover, using their handsets, subscribers can peruse and update their electronic diaries, and view their address list. Subscribers can also receive SMS notice of scheduled events in their electronic diaries.

The added value services offered by Pelephone are location-based services. *Inter alia*, these services enable, while driving, early warning of an approaching police speed trap, guidance as to the fastest route from point to point, and information regarding the nearest points at which certain services needed by the subscriber may be obtained. The service also enables employer to obtain information as to the location of employees who have cellular handsets.

Pelephone began supplying added value services at the end of 2002. In 2005 and 2006, revenues from added value services amounted to 9% and 11% respectively of revenues from cellular communications (payments for call minutes, fixed subscription fees, added value services and roaming services).

3G services – Pelephone offers its customers services using third generation technology, including, *inter alia*, viewing its various television channels such as: Music, sport, news and a variety of entertainment channels, the ability to film and transfer video files, GPS cellular services, Navigator services, high-speed 2.4 MBPS cellular modem.

At present, some 350,000 subscribers have handsets which enable use of third generation services.

Roaming services – Pelephone provides roaming services (communications via MRT from various locations worldwide), in accordance with agreements that it has with cellular providers around the world. In order to facilitate similar services in Europe and in other countries where the network is not based on CDMA technology, Pelephone leases handsets to its customers that are adapted to the technology in use in those countries, in accordance with agreements between Pelephone and cellular operators in those countries. Pelephone has a series of agreements which enable its customers to receive services in 208 countries around the world. During 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets provide an additional solution to roaming services in other countries where the network is not CDMA. In light of the lack of a variety of handsets and support of some of the handsets that Pelephone provides its customers, this solution is a partial solution only and does not address all marketing needs.

During 2006, Pelephone signed agreements with two GSM carriers, which expands its ability to provide its customers with roaming services around the world. These agreements enable Pelephone to provide its customers with broader and more varied roaming services. At the end of 2006, Pelephone was getting ready to support data transfer services under roaming, in addition to its existing support of call and sms services on GSM networks.

Maintenance and repair services – Pelephone offers its customers ongoing repair service, against a monthly payment, providing warranty for the cellular telephone.

3.2.2 **Products**

Terminal handsets – Pelephone offers its customers various kinds of mobile telephone handsets, vehicle handsets, hands-free sets and assorted accessories which support the variety of services that it provides.

3.3 **Segmentation of Revenues and Profitability from Products and Services**

The following are data on the breakdown of Pelephone revenues (in NIS millions):

	2006		2005	
	NIS millions	% of revenues	NIS millions	% of revenues
Revenues from cellular and terminal equipment services	3,861	86%	3,704	84%
Revenues from the sale of terminal equipment	617	14%	724	16%
Total	4,478	100%	4,428	100%
Percentage of gross profit	27%		25%	

3.4 **New Products**

In 2006, Pelephone expanded its added value services, and launched new services, as follows:

- Advanced road services including: Voice navigation services, speed traps warnings, fast lane location and traffic reports.
- Navigation services via the handset, using map-based GPS.
- Back-up of telephone book on network.

3.5 **Accounts Receivable**

As at the end of 2006, Pelephone had 2.427 million subscribers. Approximately 70% of Pelephone's subscribers are private customers and 30% of Pelephone's subscribers are business customers.

3.6 **Marketing, Distribution and Service**

Pelephone's distribution system is based on 40 sales and service centers and laboratories around the country, which deal in service and sale to customers, treatment of malfunctions, installation of handsets, and service and sales personnel and independent resellers spread out in 81 points of sale (some of which are operated by Pelephone employees, and others of which are operated by the independent resellers). In addition, service and sales representatives also serve the business sector.

Pelephone's subscriber service system includes 10 designated telephone call centers which provide information, service on various matters, technical support, data regarding customer billing and general information.

3.7 **Competition**

3.7.1 Pelephone faces fierce competition from the other cellular operators: Partner, Cellcom and MIRS. This competition brought about an increase in the size of the market, the addition of new subscribers and an erosion of prices. The competition is expected to increase as a result of the entry of number portability into force (see section 3.7.3 below).

To the best of Pelephone's knowledge from the data published by each of the cellular companies in Israel, as at the end of 2006, there are approximately 8.3 million cellular subscribers in Israel: Pelephone has approximately 2.4 million subscribers, Cellcom

reported approximately 2.8 million subscribers, Partner reported approximately 2.7 million subscribers and Mirs, approximately 0.4 million subscribers²⁰.

3.7.2 In September 2006, the Government approved a decision under which the Ministries of Finance and Communications were required to examine the issue of the operations of virtual providers in Israel in the field of mobile telephony, and to formulate, if necessary, a model for encouraging the operations of virtual carriers in Israel by May 1, 2007. A mobile virtual network operator (MVNO) is a cellular operator which purchases airtime from an ordinary cellular operator (which owns infrastructure) via a commercial contract. The MVNO uses existing cellular networks and sells its services to the public under a separate brand name. In January 2007, the Ministry of Communications published an RFP for consultancy services in order to formulate its position regarding the operations of an MVNO in Israel. By May 2007, prior to making a final decision on the matter, the Ministry is expected to hold a hearing for carriers in order to find out their position on the entry of an MVNO into the cellular industry in Israel. Pelephone's position is that in any event, there is no room for regulatory impositions in this area, and the company is getting ready to present this position to the Ministry of Communications, the Ministry of Finance and other relevant regulatory bodies.

3.7.3 On March 22, 2005, the joint Finance and Economics Committee of the Knesset approved an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 to the effect that the Minister of Communications is to prepare a numbering plan regarding number portability with respect to a general licensee for provision of MRT services and a licensee for domestic fixed-line communications services, and is to instruct them regarding the implementation and activation of it by September 1, 2006. The licensee is to be required to provide number portability for any subscriber that may request such, and is to do all of the acts required for such purpose without any payment from the subscriber or from any licensee. Implementation of the numbering plan shall subject Pelephone to implementation costs and activation complexities. In addition to this, implementation of the number portability plan is expected to affect competition in the field. As at the date of this Report, Pelephone, and to the best of Pelephone's knowledge, the other cellular companies and Bezeq as well, are not in compliance with the timetables, and notice in this regard has been given to the Ministry of Communications from all of the companies. The Ministry of Communications has not given notice of any change in the timetables.

On August 23, 2006, the Ministers of Communications and Finance announced that implementation of the plan would not be postponed beyond September 1, 2006. The Ministers' notice also stated that the Director General of the Ministry of Communications had recommended that if the plan is not implemented and operated by that date, "the relevant communications companies would be declared in violation of the law, with everything that entails". Following this decision, both Pelephone (together with the other cellular companies) and Bezeq filed petitions in the High Court of Justice for a decree nisi against the Government of Israel and the Minister of Communications. The petitioners allege, *inter alia*, that even though they had worked assiduously for implementation of the plan, investing considerable resources for the purpose, they are unable to meet the unrealistic timetables set in the law for its implementation. The petitioners further alleged that the Ministry of Communications had failed to prepare a number portability plan and had not prescribed a structure for the payments that would apply among the operators, as the Law requires. At this stage, Pelephone is unable to assess the consequences of the above. In a preliminary response by the State to the petition, the State dismisses the claims raised by the petitioners, and places the responsibility for non-compliance with the regulating provisions of the law on the communications companies.

Pelephone has progressed in its preparations for activating number portability, and it assesses that it will be able to commence testing with other companies on April 1, 2007. The testing process with the other carriers is estimated to take approximately 4-5 months, and will be conducted via a consultancy firm which has been chosen. After completion of the tests between the carriers, a test needs to be performed on a sample group of customers before full activation of number portability, and that test is expected to last about one month. On February 15, 2007, the Ministry of Communications wrote to the carriers

²⁰ This data relates to active subscribers having received or made at least one call in the past six months. The number of subscribers also relates to subscribers of more than one cellular carrier, or who are in the process of moving between carriers.

requesting information on the status of their preparations for number portability, based on the Ministry's intention to rewrite the timetable for implementation of the number portability plan.

- 3.7.4** On June 3, 2004 the Communications (Telecommunications and Broadcasts) (Processes and Conditions for Obtaining a General Special License) Regulations 5764-2004 were published. Under the aforementioned Regulations, an application may be filed for a special general domestic license, i.e. for a license for the provision of domestic fixed line telecommunications services, which does not involve an obligation to provide service to the entire public everywhere in Israel. Pelephone, as a subsidiary of Bezeq, is obliged, unlike the other cellular companies, to apply the Minister of Communications and persuade him that the award of a license to Pelephone, as a subsidiary of Bezeq, is such as to promote the competition in the telecommunications field or is in the public interest.

Bezeq's license imposes restrictions on it in all matters pertaining to cooperation with its subsidiaries. In the opinion of Pelephone and Bezeq, to the extent that these restrictions remain in force, without, at the same time, similar restrictions being imposed on the competing MRT operators, they will adversely affect Pelephone's ability to compete with its rivals in the industry. For the restrictions imposed on Bezeq and Pelephone by virtue of the merger conditions, see section 3.18.3 below.

During the last quarter of 2006, the Ministry of Communications has been holding a renewed hearing on the matter of final formulation of its policy regarding licensing of the supply of telephony services using broadband access (VOB). On February 1, 2007, the Ministry published its final policy document on VOB in which it prescribed that Bezeq and the companies in the Bezeq Group (including Pelephone) shall be entitled to take part in this industry only once Bezeq's market share of the domestic fixed line telephony industry falls to below a threshold of 85%. Pelephone objects to this policy and is of the opinion that it should be treated as an independent body, due also to the existence of the restrictions imposed upon it regarding joint marketing and the sale of joint bundles with Bezeq. Pelephone expressed its opinion during the hearing before the Ministry of Communications and is looking into its steps following publication of the Ministry's policy.

In August 2006, Pelephone Fixed Line Communications Partnership, which is a limited partnership that is wholly owned by Pelephone and is a subsidiary of it, submitted an application for a special general license to provide domestic fixed line telecommunications services. As part of the Ministry of Communications' policy in the area of VOB, it has determined that a response to this application shall be given separately. As at the date of the report, no response has been received.

3.7.5 Positive and negative factors affecting Pelephone's competitive position

Positive factors:

- A The advanced third generation cellular network supporting the download of data at a rate of up to 2.4 Mbps, and providing good network quality.
- B An advanced product range including DATA solutions for businesses, and a broad spectrum of multimedia and entertainment services.
- C. Service system and range of customer service interfaces enabling the provision of high-level service to customers.
- D. An extensive distribution system specializing in the provision of solutions appropriate to each type of customer, and high-quality human resources.
- E. Strong capital structure and positive cash flow.

Negative factors:

- A As a subsidiary of Bezeq, Pelephone is subject to restrictions on entering into additional fields of activity and on expanding its customer service baskets, which do not apply to the competitors.
- B There are restrictions on joint activity with Bezeq, including in the marketing of joint service bundles.
- C. CDMA technology does not enable the provision of roaming services in the same manner as this service is provided by competitors, as this technology is less common around the world.

- D. Two of the leading terminal equipment manufacturers in the world in this industry do not manufacture cellular telephones using CDMA technology for the Israeli market.

3.8 Seasonality

Pelephone's revenues and profitability are affected, albeit not to any material extent, by seasonality and holidays. The second and third quarters are characterized by higher revenues than the first and fourth quarters. This is due primarily to different usage patterns prevailing in the summer months compared to the winter months and the holiday season. Seasonal fluctuations only affect cellular services revenues, but, as stated, the effect is not material.

3.9 Property Plant & Equipment

Pelephone's fixed assets include the infrastructure equipment of the network core, radio sites, electronic equipment, computers and software systems, motor vehicles, terminal equipment, office furniture and equipment and leasehold improvements.

3.9.1 Infrastructure

3.9.1.1 Pelephone's infrastructure investments

Most of the investments in 2003-2006 were used to upgrade the network to CDMA 2000 1XRTT and EVDO technology, using equipment purchased from Nortel and Motorola. In 2006, the network capacity was expanded, additional sites were set up (some of them to replace existing sites due to engineering requirements) and the network is undergoing adjustments to support number portability (which is to be completed in 2007).

3.9.1.2 Pelephone operates two communications networks using three technologies:

- A Digital technology using CDMA2000 1XRTT. This is a state-of-the-art technology and its advantages are the ability to provide advanced services, greater capacity for talk calls and data for a given quantity of frequencies and fast data communications (up to 144KB).
- B Digital technology using the EVDO method – see section 3.9.1.6 below.
- C. Analog technology using the NAMPS (Narrow Band Advanced Mobile Phone System). This is old technology which is not undergoing network development processes, and at present, traffic over it is negligible.

The three technologies operate on the same frequency range allocated to Pelephone.

3.9.1.3 As at the date of publication of the report, Pelephone's MRT infrastructure (CDMA) is based primarily on 8 digital switches manufactured by Nortel, connected to approximately 1,435 radio sites (cells), in a countrywide spread. Each radio site incorporates an antenna for reception and transmission and a computerized control system, and covers a certain geographic area. The cells are connected to base station controls (BSC) that are hooked up to the switches. The switches are connected to one another and to all the other telecommunications operators (Bezeq, Partner, Cellcom, MIRS, HOT, and international operators).

3.9.1.4 The depreciation period for site equipment is up to 10 years. Depreciation for switching equipment is between 5 and 7 years. The depreciation period of the equipment is determined on the basis of engineering opinions based, inter alia, on generally accepted practice in various other countries.

3.9.1.5 Pelephone's infrastructure equipment is manufactured by Nortel and Motorola. Each of Pelephone's digital switching networks is manufactured by Nortel, and the Nortel telecommunications network covers most of the coastal plain and Jerusalem (from Ashdod to Haifa). The Pelephone network in the rest of Israel uses the Motorola-manufactured telecommunications network.

3.9.1.6 As of 2004, the Pelephone Board of Directors began upgrading the CDMA2000 1XRTT network to EVDO technology by means of the addition of a special-purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the terminal

equipment at rates of up to 2,400 KSS (downlink) and between the terminal equipment and the network at rate of up to 144 KSS (uplink). The EVDO equipment is manufactured by Nortel. Parallel to setting up the network, a portal was set up for video services enabling customers to view live broadcast channels, to download music clips, entertainment, news, etc. This portal is the key service using EVDO technology. This portal was extended to support dozens of video channels during 2006.

- 3.9.1.7 In 2005, Pelephone acquired equipment from Nortel, in a long-term transaction for 2005-2007, for the expansion of its network, including 150 sites and equipment to upgrade the capacity of the network. The value of the transaction was approximately \$ 20 million. Pelephone has not yet exercised the whole of this undertaking.

3.9.2 Premises used by Pelephone

Pelephone is not the owner of any land, and it leases the premises which it uses for its operations from others, including Bezeq. The following is a description of the main premises used by Pelephone:

- 3.9.2.1 The land which Pelephone uses for installation of radio and switching sites, as set out in section 3.9.1.3, are spread out around the country, and are leased for various periods (in many cases, for 5 years plus an option to extend the agreement for another 5 years). For site licensing, see section 3.18.3.3 below.
- 3.9.2.2 Pelephone's head offices have been in Givatayim since 1997, and cover a total area of 17,000 sqm. In 2006, Pelephone signed an agreement to extend the lease term until December 31, 2010.
- 3.9.2.3 For the purpose of service and sale operations, Pelephone leases 40 service and sale centers, and 51 points of sale spread out around the country.
- 3.9.2.4 Pelephone has additional lease agreements with respect to warehouses, offices and telephone call centers which it uses for the purpose of its operations.

3.10 Intangible assets

3.10.1 MRT license

Pelephone operates pursuant to a license issued to it (a general license for the provision of mobile radio telephone (MRT) services), which is valid until 2022 (see section 3.18.1.1 below). The license constitutes the basis for Pelephone's activity.

3.10.2 Frequency usage right

Pelephone uses frequencies in the 800 MHz range, granted to it by virtue of its license. These frequencies are used by Pelephone mainly for CDMA2000 1XRTT technology and EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2000 MHz ranges) using UMTS technology. In this regard, see Note 18 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

3.10.3 Trademarks

Pelephone has a number of registered trademarks. The principal ones are: The "Pelephone" trade mark, aimed at the general public and business customers, and the "Esc" trademark, aimed at the young market

3.10.4 Customer Base

Pelephone has a large number of customers, many of whom have entered into agreements to receive Pelephone's services for a period of up to 36 months.

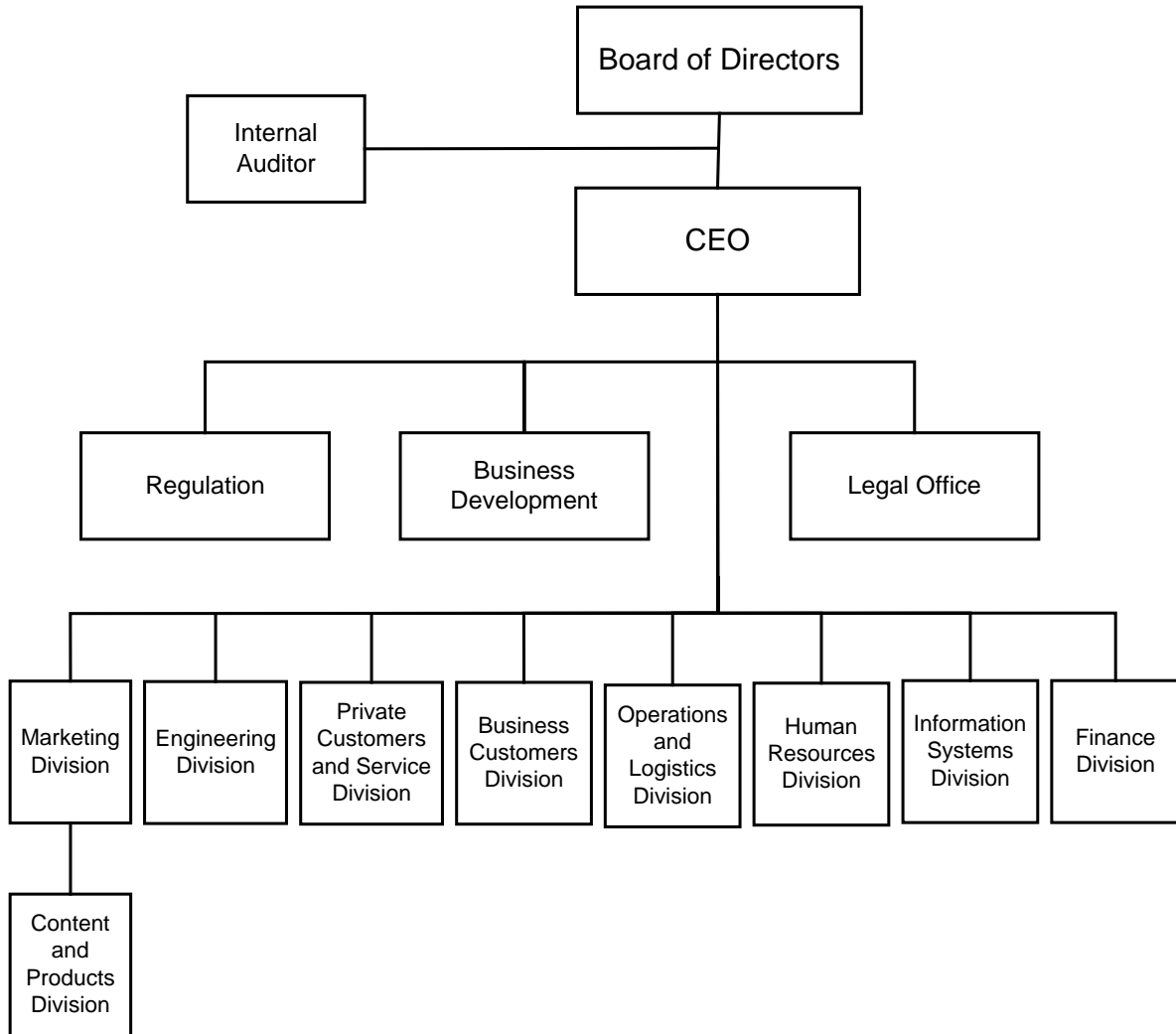
3.10.5 Software, computer systems and databases

Pelephone uses software and computer systems, some under licenses purchased by Pelephone and others developed by Pelephone's information technology division. The lion's share of these licenses are restricted in time and renew every so often. The main systems that Pelephone uses are: Oracle Application, and a billing system produced by Amdocs.

3.11 Human Resources

3.11.1 Organizational structure

The following is a diagram of Pelephone's organizational structure:



3.11.2 Table of organization

The following details the number of employees²¹ in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.06	31.12.05*
Headquarters and management	290	258
Content marketing and products division	95	84
Customer Service and Private Sector Division	2,427	2,462
Business Division	438	390
Operations and Logistics Division	306	375
Engineering and Information Systems Division	593	571
Total	4,149	4,141

* Re-classified following transfer of operations between various Divisions.

²¹ The number of employees represents the number of jobs as calculated by Pelephone (total work hours divided by monthly work-hour standard).

3.11.3 Changes in the number of employees during 2006

At the end of 2006, Pelephone's manpower stands at approximately 4,149, compared with approximately 4,141 at the end of 2005.

3.11.4 Instruction and training

Pelephone invests resources in professional training in accordance with the type of employee and the field in which he is active. Most training courses take place in the service field, primarily in the service division. Pelephone's total expenses in 2006 and 2005 in respect of instruction and training amount to NIS 9.3 million and NIS 6.5 million, respectively. The employees who work as sales and service representatives and as telephone call center employees have a high churn rate, which requires constant investment in new employees.

3.11.5 Employee and Manager Reward Schemes

It is the practice of Pelephone to award its employees and managers grants and incentives on a monthly, quarterly and annual basis commensurate with their achievement of the targets set for them and in accordance with the type of work done by the employee.

3.11.6 Employment contracts

All of Pelephone's employees are engaged on the basis of standard personal contracts in accordance with the professions and functions in which they engage.

3.12 Products and Suppliers

3.12.1 Terminal equipment suppliers

The Pelephone products' inventory includes a range of cellular telephone units and a range of auxiliary accessories (such as: batteries, hands-free kits, earphones, data cables, chargers and so forth). Pelephone also maintains inventory of spare parts for the purpose of supplying repair services to its customers and an inventory of used handsets.

Pelephone purchases the terminal equipment and accessories from a variety of suppliers and importers in Israel. Contractual engagements with most of the suppliers are based on framework agreements setting forth, *inter alia*, the technical support provided by the supplier for the terminal equipment it supplies, the availability of the spare parts and the turnaround time for repairs. These agreements include a commitment to make acquisitions, which are implemented regularly by means of purchase orders.

If a contract with a particular terminal equipment supplier is discontinued, Pelephone may increase the quantity purchased from other terminal equipment suppliers or procure terminal equipment from a new terminal equipment supplier. If the replacement of a supplier is required, as aforementioned, the replacement shall not be immediate, and shall be subject to a special preparatory period for purchasing spare parts and accessories, including the repair capacity for all kinds of malfunctions, in order to enable the provision of service to customers as agreed. Replacement of a supplier will involve the addition of exceptional costs as a result of the need to purchase equipment, and will involve a period of re-organizing affairs with the replacement suppliers.

The splitting of terminal equipment purchases between suppliers does not create significance dependency on any one supplier or equipment model.

3.12.2 Value Added Service Suppliers

Pelephone has agreements with content suppliers under which Pelephone receives content such as information services by voice mail, SMS or via Pelephone's portal, games, animations, ring-tones, location services, content and the rights to broadcast over third generation technology. As is usual in this industry, a large portion of these agreements are based on a model of dividing revenues between Pelephone and the content suppliers for the services provided to customers. Termination of contracts with certain suppliers might cause delays in supplying some of the services pending contracting with substitute suppliers.

3.12.3 Infrastructure Suppliers

As set out in section 3.9.1 above, Pelephone's infrastructure equipment is manufactured by Nortel and Motorola. Pelephone has long-term maintenance, support and software upgrade

agreements with these suppliers and depends on them with respect to support of the network equipment that they produce. For other agreements with these suppliers see section 3.9.1 above.

3.13 Working capital

3.13.1 Stock holding policy

Pelephone's inventory mainly includes cellular terminal equipment and a variety of accessories (such as: Batteries, hands-free-sets, earphones, etc.). Pelephone also holds spare part inventory.

The period in which inventory is held is a consequence of Pelephone's service policy and of its sales requirements. The requirements necessitate maintaining an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2006, the inventory level stands at an amount of approximately NIS 171 million.

3.13.2 Returns policy for terminal equipment purchased

As a rule, the return of handset inventory may be implemented by cancellation of a transaction or by the replacement of a handset for another (of the same standard or a higher standard against incremental payment to cover the price difference.)

Pelephone's policy, as at the date of this report, enables its customers to return equipment purchased within a period of 24 hours of the time of the transaction, in accordance with the agreement with customers and in with the conditions thereof, provided that no use has been made of either the product or the accessories to it.

With respect to remote sales transactions and peddling transactions as defined in the Consumer Protection Law, 5741-1981, return of equipment is permitted up to fourteen days after the date of the transaction, in accordance with the provisions of the Law.

3.13.3 Product warranty policy

Pelephone provides service, warranty and maintenance for terminal equipment in accordance with the level of service and repairs to which the customer has subscribed and of course in accordance with the provisions of any law which regulate issues of warranties for cellular terminal equipment.

3.13.4 Policy governing credit to customers

Credit in handset sale transactions – Pelephone enables most of its customers purchasing a mobile telephone to spread payments over 36 equal installments. Most of the payments for transactions are effected via credit cards. Pelephone deducts part of the transactions that are paid via credit card from payments to clearing companies.

Credit by monthly charging in respect of MRT services – Pelephone customers are charged once a month in charging cycles taking place on different dates over the course of the month, in respect of the consumption of MRT services in the preceding months.

As at 2006, total average customer credit less doubtful debts amounts to NIS 1,253 million.

3.13.5 Credit from suppliers

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2006, total average credit from suppliers and other trade payables amounts to NIS 621 million.

3.14 Investment in Investee Companies and in a Partnership

As at September 30, 2005, Pelephone held 85% of the B-one partnership (hereinafter: the "Partnership"). At the end of the third quarter of 2005, it was decided to transfer the Partnership into the full ownership of Pelephone, and as of the end of 2005, the Partnership has been operating to wind up its business.

3.15 Financing

3.15.1 Pelephone's operations are financed by shareholders' equity, bank loans, debentures, credit card clearance and supplier credit.

The average interest rate in 2006 for undesignated loans was:

	Long-term loans (including current maturities)
Banking sources	
CPI-linked – NIS	4.78
Fixed Shekel	7.23
Dollar	4.87
Non-banking sources:	
CPI-linked – NIS	4.64

3.15.2 Restrictions

3.15.2.1 Undertakings towards banks

As part of the arrangements made with banks in Israel in connection with the provision of credit to Pelephone, Pelephone provided the aforementioned banks with certain irrevocable undertakings to comply with financial covenants, consisting primarily of the following:

- A. Pelephone's total debts not to exceed three times its shareholders' equity.
- B. As long as total debts exceed shareholders' equity by more than 2.5, Pelephone shall not pay out dividends and shall not pay management fees to shareholders. If Pelephone is in breach of this undertaking, it shall, within 120 days of demand, be required to repay the bank all loans outstanding to the credit of the bank at such time, or, alternatively, to amend the breach by increasing its shareholders' equity or repaying Pelephone's loan in such a way that the aforesaid ratio is preserved;
- C. Total debts shall not exceed NIS 3.8 billion (linked to the CPI known as at January 2002). The sum of the debts shall be checked once every quarter in accordance with the financial statements that have been reviewed by accountants;
- D. Not to mortgage Pelephone's assets under a fixed or floating charge, in any manner or way, or of any kind or degree, without obtaining the bank's prior written consent to such;
- E. Not to provide Pelephone's shareholders or any third party whatsoever with any security or charge over the assets of Pelephone or any guarantee to secure credit received by the shareholders, without obtaining the prior written consent of the banks to such;
- F. Not to grant Pelephone's shareholders any loan or credit without obtaining the bank's prior written consent to such;
- G. To provide the banks with various information, details and reports;
- H. If Pelephone is in breach of its aforementioned undertakings, then the banks shall be entitled to call for immediate repayment the amounts of the loans extended to it.
- I. Undertaking to a particular bank – in addition to the above undertakings, Pelephone has undertaken to ensure that the cumulative sum of all of its debts and liabilities towards a particular bank shall be no greater than the equivalent of 40% of the cumulative sum of all of Pelephone's debts to financial entities including debentureholders.

3.15.2.2 Immediate repayment of the loan

A lender may call a loan for immediate repayment in certain instances (usually after serving written warning notice on Pelephone), foremost among such instances being:

(A) if any debt to the lender was not paid; (B) if Pelephone adopts a liquidation resolution or if application for liquidation or for the appointment of a liquidator is filed against it or if there is cause for its being liquidated, or for the appointment of a receiver or a trustee; (C) if application is filed for the imposition of an attachment or if an attachment is imposed on the assets of Pelephone or if any execution proceeding is taken against its assets or if it ceases to repay its debts; (D) if Pelephone adopts a resolution in favour of restructuring, merger or settlement or if the control therein is transferred without the lender's consent; (E) if Pelephone ceases to repay its debts or reaches a compromise with its creditors or any of them; (F) if Pelephone is in breach of any undertaking that it has assumed toward the lender or if it should transpire that a material declaration by Pelephone toward the lender is untrue; or (G) if an event should have occurred as a result of which any entity shall have the right to call for immediate repayment of Pelephone's debts towards it (even if such concerns does not make use of its right).

3.15.3 Issue of Debentures

In 2004-2005, Pelephone issued three series of index-linked debentures by way of private placements to institutional investors in a total sum of NIS 1,133 million par value, in consideration for their par value.

At the time of issue of the debentures, trust deeds were executed by the Company, for the trusteeship of Union Bank of Israel Ltd., which is to act as trustee for the debenture-holders. Pursuant to this agreement, Pelephone undertakes to pay principal, interest and indexation differences in accordance with the terms of the debentures. The debentures are not secured by any charge, and the conditions of the negative pledge and financial criteria that Pelephone maintains in relation to the Israeli banking system will also apply to the debenture holders (see section 3.15.2 above). The agreement details the conditions for immediate repayment of the debentures, being essentially as follows: (A) If Pelephone does not repay any amount whatsoever being due from it pursuant to these debentures by 30 days from the due date; (B) if a liquidator is appointed for Pelephone; (C) if charges are realized; (D) if an attachment is imposed on material assets of Pelephone; (E) if Pelephone ceases to exist or (F) if Pelephone discontinues its payments or serves notice of its intention to discontinue them. The trustee is entitled to take steps for immediate repayment in order to protect the debenture holders. The agreement moreover determines forth principles for indemnifying the trustee, trusteeship of the receipts, investment of moneys and conditions for convening a general meeting and adopting resolutions.

As at December 31, 2006, Pelephone is meeting its commitments to the banks and to the debenture holders.

In 2006, no new long-term loans were taken.

For additional details regarding the composition of the loans and debentures, the conditions thereof and the date of repayment thereof during the report period, see Note 13 to the financial statements of the Company for the year ending December 31, 2006, which are included in this periodic report.

3.15.4 Credit limits

Pelephone's credit limits at banks in Israel amount to approximately NIS 2.09 billion as at 31, 2006. There are no signed agreements with the banks regarding this sum, but rather, there are oral agreements and non-binding written consents. As at December 31, 2006, Pelephone had utilized NIS 736 million of its credit limit at banks.

3.15.5 Guarantees and charges

See Notes 13 and 19 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

3.15.6 Credit rating

The rating company Maalot assigned Pelephone an AA minus rating on the placements of the debentures (see section 3.15.3 above). In December 2006, Maalot published a follow-up rating under which Pelephone was rated AA minus yet again.

3.15.7 Pelephone's estimate of fundraising in the coming year and sources of financing

Pelephone expects to repay a large portion of its loans during 2007, and it plans additional investments in property, plant and equipment. If necessary, Pelephone will raise new loans from banking corporations and/or by raising capital on the capital market.

The above information includes forward-looking information that is based on Pelephone's assessments taking into account its plans and the expectation that such will be realized. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.16 Taxation

See Note 8 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

3.17 Environmental matters

3.17.1 Provisions regarding environmental protection – see section 3.18.1.3 below.

3.17.2 Anticipated costs and investments

Pelephone conducts periodical radiation tests in order to ascertain that it is in compliance with the permitted operating standards and the standards of the International Radiation Protection Agency. These tests are outsourced to companies authorized by the Ministry for the Environment. Pelephone invests on average NIS 4 million per annum in respect of this activity.

3.18 Restrictions on and Control of Pelephone's actions

3.18.1 Statutory restrictions

3.18.1.1 Communications Law and licensing obligation thereunder

The Communications (Telecommunications and Broadcasts) Law 5742-1982 stipulates, inter alia, that that performance of telecommunication activity and the provision of telecommunication services, including the MRT services, are subject to a license from the Minister of Communications (in this chapter – the Minister). Pelephone holds a general license for the provision of MRT services. The Minister is empowered to modify the terms of the license, to add thereto or to detract therefrom, while taking into consideration, inter alia, government telecommunications policy, considerations of public interest, suitability of the license holder to provide the services, the contribution of the license to competition in the telecommunications field and to the level of service therein. Moreover, the Minister empowered to annul, restrict or suspend a license in a number of situations (see Section 3.18.3.1 below).

The Law authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms. In this regard see also Section 2.16.13 above.

3.18.1.2 The Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance [New Version] 5732-1972 (hereinafter: "**The Telegraph Ordinance**"), regulates the use of the electromagnetic spectrum, and applies, inter alia, to the use made by Pelephone of radio frequencies, as part of its infrastructure. The set-up and operation of a system making use of radio frequencies is subject, under the Telegraph Ordinance, to the issue of a license, and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel (inter alia, due to the allocation of a great many frequencies for security uses), by limiting the number of licenses issued for

the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of a low range frequency on the other.

The Wireless Telegraph (Licenses, Certificates and Fees) Regulations 5747-1987, stipulate various fees for business stations (including MRT business stations), MRT, point to point wireless lines, satellite stations etc. For the allocation of radio frequencies to Pelephone, see section 3.10.2 above.

3.18.1.3 Facilities emitting electromagnetic radiation

Use of facilities that emit electromagnetic radiation is regulated in law as follows:

The Pharmacists (Radioactive Elements and Products) Regulations 5740-1980, regulate, inter alia, relate to electromagnetic radiation in facilities emitting such radiation, and the are applicable to some of Pelephone's facilities. The setting-up of such a facility and such activity are subject, inter alia, to a permit from the Commissioner for Environmental Radiation at the Ministry of the Environment, and the Commissioner is entitled to render the issue of a permit contingent on certain conditions, both for the issue thereof and for the validation thereof post-issuance. The Commissioner is also entitled to issue directives as to the adoption of appropriate measures such as he may enumerate, if he is of the opinion that the facility is liable to jeopardize the health or wellbeing of an individual or the public or the environment. Non-fulfillment of the regulations or the terms of the permit or the Commissioner's directives is cause for revoking or suspending the permit.

On December 20, 2005, the Non-Ionized Radiation Law 5766-2005 was passed, the commencement of which, for the purpose of regulation of radiation licensing, was set down for January 1, 2007. The provisions of the Law required a re-examination of Pelephone's preparations regarding compliance with the conditions of the Law.

One of the provisions of the statute provides that grant by the Radiation Commissioner at the Ministry of the Environment of a permit to operate cellular sites shall be conditional upon obtaining a building permit. Pelephone is acting to comply with statutory provisions as aforesaid and as at the date of this report, approximately 83%²² of the sites in which Pelephone operates are authorized for the purposes of building permits. For the rest of its sites, Pelephone does have valid operating permits under the transitional provisions of the Law, and is working to obtain permits or alternative solutions in respect thereof.

3.18.1.4 The Consumer Protection Law

During the course of its operations, Pelephone is subject to the Consumer Protection Law, 5741-1981 (hereinafter: the "**Consumer Protection Law**"). In December 2005, the Consumer Protection Law was amended so that the prohibition against misleading conduct contained in the Law immediately prior to entry of the amendment into force, and the option of suing on grounds of misleading conduct by a dealer prior to the date of the contract, was extended to include misleading conduct by a dealer after the date of the contract.

3.18.2 Controlled tariffs

Payments for interconnections:

The Telecommunications (Payments for Interconnection) Regulations 5760-2000 (hereinafter: the "**Regulations**") prescribe limitations regarding payments to be made or to be received from a domestic carrier or another MRT carrier under the Regulations. In December 2004, the regulations were amended as follows:

- A For the purpose of interconnectivity payments received from a domestic operator or from another MRT operator for completion of one traffic minute on an MRT network, the current tariff for call completion is to be scaled down gradually to NIS 0.22 in accordance with the following outline (tariffs do not include VAT):

²² This figure includes approximately 13% of sites defined as access installations. These installations are exempt from building permits, although there are certain local councils which claim that such a permit is required and the matter is currently in the process of being examined in legal proceedings that were instituted by some of the authorities, and there are a number of private initiatives by Members of Knesset to amend the exemption granted in the law.

1. As of March 1, 2005, the current tariff of NIS 0.45 per traffic minute was reduced to a maximum tariff of NIS 0.32.
 2. As of March 1, 2006, the tariff was reduced to a maximum tariff of NIS 0.29.
 3. As of March 1, 2007, the tariff will be reduced to a maximum tariff of NIS 0.26.
 4. As of March 1, 2008, the tariff will be reduced to a maximum tariff of NIS 0.22.
- B. With respect to payments received from an international licensee for completion of traffic on an MRT network, the current tariff of NIS 0.25 for call completion will be reduced, as of March 1, 2008, to a maximum tariff of NIS 0.22.
- C. With respect to payments received from another MRT carrier for transfer of short messages (SMS) over an MRT network, the tariff was reduced in a two-stage format so that as of March 1, 2005, the maximum tariff for all SMS messages was set at NIS 0.05 and as of March 1, 2006, this tariff was reduced to a maximum tariff of NIS 0.025.
- D. The tariffs in paragraphs (A) to (C) above will be revised once a year, commencing March 1, 2006, in accordance with the rate of change of the Consumer Price Index.
- E. For the purpose of calculating payment for airtime and call completion to an MRT network, as of January 1, 2009, the charge will be made in accordance with segments of one second (unlike the current charging system which enables charging per segments of up to 12 seconds). Consequently, as of January 1, 2009, the payments payable by the MRT operator for interconnect services to a domestic operator's network will also be revised.

The following table itemizes tariff development:

Date	Domestic interconnect (per minute tariff)	International interconnect (per minute tariff)	SMS
To Sep 2000	62.0	62.0	
From Oct 2000	54.0	25.0	
From Jan 2002	50.0		
From May 2002	50.0		38.0
From Jan 2003	45.0		
From May 2004	45.0		28.5
From Mar 2005	32.0		5.0
From Mar 2006	29.69	25.6	2.56
From Mar 2007	26.59		
From Mar 2008	22.45	22.5	

Note: The tariffs are presented in Agorot and are exclusive of VAT. The tariffs as of March 2008 are adjusted for the CPI known in January 2007.

3.18.3 License and site licensing

3.18.3.1 Pelephone's license

The General License for the provision of MRT services granted to Pelephone on February 7, 1996 was for a period of 10 years commencing January 1, 1994, with an option of extending it for additional periods of 6 years each, under the conditions set forth in the license, consisting primarily of compliance with statutory conditions. Following the tender in which Pelephone was allotted third generation frequencies, the license was extended to be valid for 20 years as of September 9, 2002. For the arrangement with the State regarding the right to use frequencies, see Note 18 to the financial statements of the Company for the year ended December 31, 2006, included in this periodic report.

Likewise, in April 2001, the Civil Administration for the Judea and Samaria Region awarded Pelephone a general license for the provision of MRT in the region of Judea and Samaria, applicable to which (with some changes) are the provisions of the general license awarded to Pelephone by the Ministry of Communications.

The following are the principal provisions of Pelephone's license (hereinafter: in this section "**the licensee**"):

- A Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, and in certain instances to revoke it.
- B The license is non-transferable, and neither may 10% or more of any means of control in the licensee be transferred either directly or indirectly, nor may any means of control in the licensee or any portion of any means of control be transferred in any manner in such a way as to confer control on the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.
- C A shareholder in Pelephone or a shareholder in an interested party therein may not mortgage his shares in such a way that realisation of the lien will result in a change of ownership of 10% or more of the means of control in the licensee, unless the agreement contains a provision whereby the lien may not be realised except with the prior consent of the Minister.
- D The licensee shall take steps to establish interconnectivity of the network to another public telecommunications network in the State of Israel (including towns, military sites, and military bases in the areas of Judea and Samaria and the Gaza Strip). The licensee is obliged to provide interconnect service on equal terms to any other operator and must refrain from any discrimination in implementing interconnectivity
- E The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest²³ over another licensee, whether for the payment for the service, whether in the conditions of the service, whether in its availability or otherwise.
- F The licensee is not entitled to sell, to lease or to mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for:
 - (1) Charging of any of the licensee's assets in favor of a banking corporation duly operating in Israel, for the purpose of obtaining bank credit, provided that notice shall have been served on the Ministry of Communications regarding the lien proposed to be made, whereby there is included in the mortgage agreement a clause ensuring that realization of rights by the banking corporation will not, in any event, result in any damage whatsoever to the provision of the services pursuant to the license.
 - (2) Sale of items of equipment during an upgrade procedure, including sale of equipment by the trade-in method.
- G The director (under the license: the Director-General of the Ministry of Communications) or whoever he shall have empowered for the purpose of the license, is entitled to issue directives concerning numbers mobility such that any subscriber of another MRT licensee may transfer to and become a subscriber of the licensee or receiving services from the licensee without changing his telephone number, and vice versa, and in such case, the licensee must incorporate into its telecommunications network devices enabling the application of such feature, as instructed by the director.
- H During states of emergency, whoever shall have been statutorily empowered therefor shall have the authority to issue the licensee with certain instructions as to its mode of operation and/or mode of provision of services.
- I The license sets forth the types of payments that the licensee is entitled to collect from its subscribers for cellular services, the mechanisms of setting

²³ "Company with an interest" - as defined in the Telecommunications (Processes and Conditions for Obtaining a General License for the Provision of Domestic Fixed Line Telecommunication Services) Regulations 5760-2000. These Regulations define a company with an interest as "a parent company, subsidiary, sister company, interested company, affiliate, related company or partner company" and each of these terms is defined in the Regulations.

tariffs, the reports the licensee is obliged to submit to the Ministry of Communications and also the duty of serving notice on the Ministry of Communications prior to modifying tariffs. The license also determines the Minister's power to intervene in tariffs, in certain cases.

- J The license commits the licensee to a minimal standard of service, including setting up of service call-in centres, the determination of a maximum period for repair of malfunctions, an accounts collection procedure, protection of the privacy of the recipient of the service and so forth.
- K To secure the licensee's undertakings and also in order to compensate and indemnify the State of Israel in the event that it sustains damage due to acts of the licensee, the licensee must furnish a bank guarantee in the amount of \$ 10 million. The license determines the instances in which such guarantee maybe forfeited.

As aforesaid, the Minister is authorized to amend, add to or detract from the conditions of the license. The following are the principal amendments to Pelephone's license that are being examined by the Ministry of Communications or that were recently imposed:

- A Recently, the Ministry of Communications amended the licenses of cellular carriers regarding restriction of access to the internet by users for the purpose of obtaining services including adult content. The amendment provides, *inter alia*, that access to erotic services contained in the cellular portal or via an application such as a search engine, included in the cellular portal and enabling access to sites on the internet shall be blocked by default to all subscribers, and only adults over 18 years old may request to have the obstruction removed from their cellular telephones, using the reliable identification procedure. The amendment to the licenses came into force on March 30, 2006. Partner and Cellcom petitioned the High Court of Justice against this amendment.
- B The Ministry of Communications prescribed, in an amendment to the MRT licenses which came into force on January 7, 2007, that subscriber's who are redirected to voice mail shall be given the option of disconnecting without charge, by a preliminary message informing the subscriber that he is being transferred to voice mail, the charge being imposed only after that message. Pelephone implemented the amendment on time as prescribed by the Ministry of Communications. According to the data received to date regarding call disconnections by subscribers before reaching voice mail as a result of the preliminary message, substantial harm is expected to be caused to Pelephone's revenues.
- C. In August 2006, the Ministry of Communications wrote to the cellular companies asking for a response to its intention to amend the companies' license regarding removal of the connection between an MRT terminal handset purchase transaction and the giving of benefits. According to the proposed amendment to the license, the licensee is not to create any connection between a transaction for the purchase of terminal equipment from MRT companies and the provision of a financial benefit for consumption of air time, or other benefits. In light of this, the Ministry of Communications is considering cancelling the connection between the sale of terminal equipment by the carriers and giving benefits relating to MRT services. That is so as to enable cellular company subscribers who have purchased terminal equipment from another provider or from equipment suppliers who are not cellular providers, to receive the same conditions, including monetary credit for consumption of air time, to which they would have been entitled had they purchased the terminal equipment from the cellular company in which they are subscribers. Pelephone expressed its objection to the aforesaid license amendment and submitted an economic opinion together with its objection. At this stage, Pelephone cannot assess the effect of the amendment of the license as aforesaid if it is passed.
- D. In September 2006, the Ministerial Socio-Economic Committee approved the proposal by the Ministry of Communications to amend the Communications

(Telecommunications and Broadcasts) Law, 5742-1982 (the “**Communications Law**”) so as to enable an increase of the fines that the Ministry may impose on communications companies for breaches of the provisions of the Communications Law. According to the proposal, which was approved, a licensee whose revenues during the financial year preceding the date of the breach were more than NIS 100 million shall be fined the sum of approximately NIS 1.4 million (seven times the fine set out in section 61(a)(4) of the Penal Law) plus 0.25% of the total revenues of the licensee during the financial year preceding the date of the breach. This amendment was approved by the Knesset in January 2007, as part of approval of the Arrangements Law.

In September 2006, the Ministry of Communications submitted a proposal for a broad-based amendment of the Communications (Amendment No. 34) Law.

Under the proposed amendment, the government will be given special powers during communications crises in times of national emergency. During the discussions before the Economic Committee of the Knesset, and as part of the drafting of the bill for Second Reading, a request was made to extend the application of “communications crises” to include scenarios that are not a national emergency, such as communications failure by a particular communications carrier, which harms the whole population or part thereof. Therefore, the Ministry decided to extend the amendment by adding a new section 13B. Pelephone has expressed its objection to this amendment by addition of the new section 13B, but the Ministry of Communications did not accept its position.

The bill was approved upon Third Reading in the Knesset in November 2006.

The above information includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.18.3.2 Royalties

Pursuant to the Telecommunications (Royalties) Regulations, 5761-2001 and its license, Pelephone pays royalties to the State of Israel out of its revenues which attract royalties from the provision of telecommunications services, *inter alia* less revenues and expenses in accordance with the guidelines in the Royalties Regulations. In 2006, the rate of these royalties amounted to 3% of its royalty-attracting revenues. Under the Regulations, the rate of royalties is to reduce by 0.5% to a rate of 1% from 2010 and onwards, so that in 2007, Pelephone will pay royalties in a rate of 2.5%, in 2008 - 2%, in 2009 - 1.5% and from 2010 onwards - 1%. In this regard, see also reference to a lawsuit filed by the State of Israel against Pelephone with respect to non-payment of royalties in Note 17(a)(20) to the Company's financial statements for the year ended 2006, included in this periodic report.

3.18.3.3 Site licensing

Pelephone's MRT service is provided, *inter alia*, through cellular sites spread over Israel in accordance with engineering requirements. The constant need to upgrade and improve the quality of the MRT services necessitates setting-up the cellular sites, or changes in configuration or changes in existing antenna systems.

The erection and operation of cellular antenna necessitates building permits from the various planning and building committees, a procedure requiring, *inter alia*, a number of approvals from Government concerns and regulatory bodies, including:

- A Approval for erection and operation from the Ministry of the Environment (See Section 3.17.1 above)

B Approval of the Civil Aviation Administration in some cases.

C. Approval of the IDF.

Pelephone (and its competitors) encounters difficulties in obtaining some of the required approvals, and in particular approvals from planning and building authorities.

Pelephone's ability to maintain and preserve its MRT service quality and also the coverage, is based partly on its ability to set up cellular sites and to install infrastructure equipment, including broadcasting sites. The difficulties encountered by Pelephone in obtaining the required permits and approvals may adversely affect the existing infrastructure, the network's performances and the setting-up of any additional cellular sites required by the network.

The inability to resolve these problems on a timely basis is even liable to prevent the attainment of the service quality goals specified in its license.

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the IDF, even though the applications for the approvals have long since been in the hands of those authorities. Similarly, administrative or other delays occur in some planning and building authorities in the issue of building permits for sites. Therefore, Pelephone (and its competitors) operate a number of broadcast sites without having any building permits, and this is regulated under the Non-Ionized Radiation Law (see section 3.18.1.3 above). Applications for the building permits have been filed by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

The erection of a broadcasting site without obtaining a building permit constitutes a breach of the Planning and Building Law, 5725-1965, and in some instances, this has resulted in the issuance of demolition orders against sites or the filing of indictments or the adoption of civil proceedings against Pelephone and some of its office bearers.

As at the date of this report, Pelephone has in most of the above cases succeeded in making arrangements in respect of the deficient licensing, in avoiding demolition or in delaying execution of demolition orders pursuant to arrangements reached with the planning and building authorities. These arrangements have not necessitated any admission of guilt, and/or conviction of office holders acting on behalf of Pelephone. However, it is not certain that this state of affairs will continue in the future, or that there will be no further instances in which demolition orders are issued or indictments filed in respect of building permits, including against office holders.

Pelephone, like Israel's other MRT operators, is liable to be required to dismantle broadcasting sites for which the necessary approvals and permits have not been obtained in accordance with the dates prescribed at law. If it is legally required that sites in a given geographic area be simultaneously demolished, service in that area is liable to deteriorate, until substitute broadcasting sites can be built.

Likewise, Pelephone, like Israel's other MRT operators, provides internal relays inside buildings in order to provide service in the buildings. These relays are small facilities that are attached to external antennas of around 60 cm in length. This antenna enables a broadcast signal to be received from a close broadcast site, which is then relayed into the building. Radiation emissions from these kinds of small antennas are similar to emissions from cellular terminal equipment. These relays have received a class approval from the Ministry of Communications.

Given the planning authorities' lack of clarity in policy matters relating to internal relays, and the work patterns of all of Israel's MRT operators, permits were not sought from the planning authorities in respect of these internal relays.

The Ministry of the Environment is preparing a procedure for the issue of permits for the setting-up and operation of broadcasting facilities of the same class ("class permit") the purpose of which is, inter alia, to simplify the licensing process of miniature installations and internal relays. If the planning authorities decide that

permits are also required for the installation of facilities of this type, such decision could negatively impact the installation of such facilities.

What is more, on December 20, 2005, the Non-Ionized Radiation Law, 5766-2005 was passed by the Knesset, the commencement of which, with respect to the regulation of radiation licensing, has been set down for January 1, 2007. Implementation of the provisions of the Law and the procedures that are to be prescribed under it required Pelephone to make appropriate arrangements which were in fact made. In addition, the very fact that the operations permits under the Law are subject to receipt of a building permit constitutes yet another obstacle on the way of delaying adjustment of the network as aforesaid.

3.18.3.4 Establishment of communications installations - National Outline Plan 36

The National Outline Plan for communications (hereafter: "**NOP 36**") was designed to regulate the spread and manner of setting-up of communications facilities in order to secure the functioning thereof, with full coverage of the State territory, for radio, television, and wireless communications transmission and reception, while minimizing damage to the quality of the environment and the landscape.

NOP 36A is supposed to simplify and streamline the setting-up processes of miniature and small broadcasting facilities. It stipulates clear obligations and guidelines and creates a uniform framework for processing permit applications. Approval of NOP 36A did not give rise to the regulation desired and many planning authorities have complained about the provisions of the plan, and in particular, about the following two matters:

1. Removal of the planning discretion in their regions;
2. Exposure of them to claims due to reduction of value under Section 197 of the Planning and Building Law, and failure to impose an obligation on the cellular companies to indemnify the committees for claims that might be made against the planning authorities.

This state of affairs caused no end of discussions between the cellular companies and the planning committees, which brought with it a multitude of claims in this area. Likewise, the planning committees have campaigned strongly to amend NOP 36A.

As a result of that, at the beginning of 2005, the National Planning and Building Council adopted the following resolution:

1. No building permit shall be issued unless the applicant for a permit deposits a deed of indemnity with the local authority in respect of compensation pursuant to Section 197 of the Planning and Building Law, to cover such compensation as the committee may be ordered to pay. Section 197 of the Planning and Building Law confers on landowners injured by a plan applied on their land or on neighboring land the right to compensation from the local committee. The described amendment of NOP 36A is liable to subject Pelephone to not inconsiderable financial obligations in respect of the decrease in value of properties as a result of the positioning of cellular antennae adjacent thereto. However, at this stage, there is no certainty as to either these obligations nor the extent thereof, in Pelephone's assessment they are not very likely, and they will not, of course, result automatically from the decision of the national council to amend NOP 36A.
2. Further to the directives of the National Council as at August 3, 2004, the drafting committee will formulate an amendment to the NOP with respect to extension of the local committees' discretion, and notification of the public.
3. When the draft resolution concerning extension of the discretion of local committees is submitted to the Council, the possibility of changes in the indemnification obligation and the extent thereof will be examined.

All the aforementioned resolutions are subject to Government approval.

On July 24, 2005, the government of Israel resolved to defer approval of the resolution of the National Council for Planning and Building to amend National

Outline Plan 36A dealing with the setting up of small and miniature broadcast facilities for the time being. The amendment revolved around extending the discretion of the local committees, granting a right of objection to the public and requiring the companies to make undertakings to indemnify the planning committees for claims for devaluation of land. The MRT companies' share of the indemnification was set at 80% of the devaluation, the balance to be borne by the local councils. This postponement was intended to allow the CEO committee that was set up, to submit its conclusions within three months. The Committee submitted its conclusions to the government, which set out its recommendations, the main ones being:

1. Creating a distinction between small and large sites, the licensing process for small sites being either via an exemption from license track or a fast licensing track, whilst for large sites, a complex licensing process will be required, including giving the public the opportunity to express its objections.
2. A distinction is to be made between small and large sites with respect to the amount of indemnity required on the basis of the principle that: The greater the discretion of the planning authority and the integration of residents in the objection process, the greater the rate of indemnity.
3. Likewise, implementation of the committee's recommendations requires an amendment to the Planning and Building Law, and therefore, it is not possible to estimate the timing of the end of this process. At the same time, the recommendations of the CEO Committee have been submitted to the National Council for the purpose of examining the integration of such recommendations into the National Outline Plan.

At the same time as all this, the Knesset has conducted a comprehensive amendment of the Planning and Building Law, as part of the Non-Ionized Radiation Law, under which it imposed an obligation to provide indemnity as a condition for the grant of a building permit, provided that such requirement is in accordance with the guidelines of the National Council which may be in force until provisions in this regard are set out in the National Outline Plan.

The National Council resolved, as an interim measure, to impose an indemnity obligation at a rate of 100% on the cellular companies, until any other prescription is made under NOP 36.

This state of affairs will have severe implications on the ability of the cellular companies (including Pelephone) to develop their networks, and the existence of an indemnification obligation might impose an inestimably heavy economic burden on them. Pelephone's assessment as aforesaid is forward-looking information which might not come to fruition.

In the past month, the drafting committee of the National Council has held a series of discussions in order to formulate its recommendations for the Council's plenum regarding amendment of NOP 36, including the issue of indemnity and the rate thereof.

As at the date of this update, Pelephone has deposited 85 deeds of indemnity under the Law with various local councils.

3.18.4 Antitrust

The document setting out the conditions of the merger between Pelephone and Bezeq sets out various restrictions as to cooperation between the companies. During the course of 2006, Pelephone applied to the Antitrust Commissioner to cancel the conditions of the merger with Bezeq or to provide relief for such conditions so as to enable cooperation between it and Bezeq. Pelephone has not yet received a response from the Antitrust Authority.

3.18.5 Standards

Pelephone conducts routine durability and quality control tests of its facilities. The quality control and supervision do not detract from Pelephone's responsibility towards its customers for the quality of the services it provides.

In April 1996, the Israel Standards Institute found Pelephone to be in compliance with the requirements of Israel Standard ISO 9001 2000 edition, in the field of mobile radio telephone (cellular) services.

The certificate was awarded on January 11, 2004, and is valid until October 2007.

ISO 9001 2000 edition consists of a series of standards for quality management in the services. This is a standard for quality control systems that defines requisite conditions for compliance with service process standards and also constant improvement and testing of the efficacy of the quality management system and its components.

Pelephone carried out the required adjustment for obtaining the approval in line with the tendency of the business-industrial world in general and the tendency of its customers in particular, to contract exclusively with suppliers meeting the requirements of the Standard.

3.19 Substantial agreements

For undertakings to banks, see section 3.15.2 above.

For trust deeds signed with the Union Bank Trust Company Ltd. at the time of issue of debentures, see section 3.15.3 above.

3.20 Joint venture agreements

For joint venture agreements with content suppliers regarding added value services, see section 3.12.2 above.

For roaming agreements see section 3.2.1 above.

3.21 Legal proceedings

For legal proceedings, see Notes 15 and 17 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

3.22 Goals and Business Strategy

Pelephone's principal strategic goals are:

1. Improve profitability;
2. Lead with third generation technology;
3. Grounding Pelephone's brand as valuable in the field of mobile entertainment and in the private and business sector.
4. Increasing its market share in the long term.

Pelephone operates in accordance with the following brand values: Simplicity, fairness, flexibility and innovative empowerment.

In order to achieve its goals, Pelephone is operating on a number of levels:

1. Increasing customer satisfaction

Pelephone acts to increase its customers' satisfaction and to strengthen their loyalty to Pelephone's services. These operations are expressed in an improvement of the service system, terminal equipment upgrading offers, and the grant of benefits to Pelephone's customers under a marketing shell which reinforces the Pelephone-customer relationship.

2. Leading the third generation

Pelephone has set itself a goal of being third generation leader in the Israeli market. This leadership will be expressed by an increase in revenue from third generation services and by the number of subscribers who join such services.

Leadership will be attained by:

- A Launching a broad range of third generation handsets.
- B Setting up a communications structure to cover all content.

C. Placement of Pelephone as a company that supplies the best 3G cellular entertainment.

3. Continued investment in infrastructure

Pelephone is considering setting up another cellular network using UMTS technology (see section 3.1.5.3 above).

The above information includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.23 Development outlook for the coming year

During 2007, a number of factors are expected to affect Pelephone's activities, the principal ones are as follows:

3.23.1 Continued reduction of interconnectivity fees

As set out in section 3.18.2 above, on March 1, 2007, interconnect fees will drop by another 3 Agorot. This reduction might harm Pelephone's revenues.

3.23.2 Third generation services

Pelephone expects that during 2007, it will increase the amount of customers that use third generation services, it will increase its supply of such services and as a result, Pelephone will continue to increase its revenues in this field.

3.23.3 Innovative added value services

In 2007, Pelephone is expected to continue to launch a diverse range of advanced added value services that will help improve the perception of the brand and increase revenues from existing customers such as:

- IM – the ability to send instant messages similar to ICQ or MSN Messenger.
- ICOM – development of photographs using MMS.
- Personal clips – a platform for preparing personal clips for sending by MMS or email.
- Search for me – an IVR service for finding the precise location of children.

3.23.4 Number Portability

Number portability might ease the transition of customers from Pelephone's network to those of its competitors. In Pelephone's assessment, after number portability comes into force (see section 3.7.3 above), the transition of customers between cellular carriers will increase and this might have an adverse effect on Pelephone's financial results.

3.23.5 Set-up of another cellular network

During the course of 2007, Pelephone's competent organs are expected to pass a resolution regarding the setting up of an additional cellular network using UMTS technology (see section 3.1.5.3 above).

The information in this section includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.24 Event or matter deviating from the ordinary course of the corporation's business

For presentation anew of the financial statements in accordance with Israeli accountancy rules (balance sheet as of date of transition, profit and loss for 2005 and balance sheet for December 31, 2005), see Note 33 to the financial statements of the Company for the period ended December 31, 2006, included in this periodic report.

3.25 Discussion of Risk Factors

The Israeli market in which Pelephone operates is substantially stable, however, there are risk factors which stem from the macro economic environment, from the unique qualities of the industry in which Pelephone operates, and from risk factors that are unique to the Company.

3.25.1 **Macro-economic risk factors:**

- 3.25.1.1 Recession – an economic recession in Israel might bring about a reduction in private consumption in general and in consumption of cellular services in particular, some of which are considered luxuries.
- 3.25.1.2 Exposure to fluctuations in exchange rates, interest rates and inflation – Pelephone is exposed to risks caused by fluctuations in exchange rates, since most purchases of terminal equipment, accessories and spare parts are in US dollars, whilst Pelephone's income is in Shekels. Erosion of the shekel as against the Dollar might harm Pelephone's profits in the event that adjustment of sale prices is not permitted in the short term. Accordingly, Pelephone is investing a considerable share of its cash balances in deposits that are exposed to changes in real yields as a result of inflation rate fluctuations. Those of Pelephone's loans and debentures that are linked to the consumer price index bear fixed interest and therefore fluctuations in the interest rate will affect the fair value of them, but not their on-book value.

3.25.2 **Industry-based risk factors:**

- 3.25.2.1 Investments in infrastructure and technological changes – the cellular market in Israel and elsewhere is characterized by material capital investments in the deployment of infrastructure and in subscriber equipment. The frequent technological changes in the field of infrastructure and terminal equipment, and also the fierce competition over various market segments, impose a heavy financing burden on the companies operating in the market, which necessitates updating their infrastructure technology from time to time or to penetrate new appliances into the market at heavy cost.
- 3.25.2.2 Customer credit – Pelephone's sales to its customers are mostly done on credit. Some of this credit is secured using credit insurance which includes policyholder's contributions, and some is secured by sureties provided by customers. The other part of this credit, which is not covered by either insurance or sureties, is exposed to risk. Due to the large spread of its customers, Pelephone assesses that the extent of its risk of substantial harm to its business results is low.
- 3.25.2.3 Regulatory developments – in the area of Pelephone's operations, there is a trend to legislate and impose standards on issues such as the environment, increased competition, product liability and the methods used for repairing products, etc. These regulations might increase the costs of services and marketing, and due to the stronger competition it might not be possible to roll those costs in full onto consumers, as a result of which, profits in the industry might be eroded.
- 3.25.2.4 Competition – the cellular market in Israel is characterized by a high degree of saturation, strong competition and is exposed to influences and competition as a result of technological developments.
- 3.25.2.5 Electromagnetic radiation – Pelephone operates hundreds of transmission facilities that emit electromagnetic radiation (see Section 3.18.1.3 above). Pelephone is taking steps to ensure that the levels of radiation emitted by the aforementioned transmission facilities do not exceed the radiation levels permitted by the directives of the Ministry of Environment (levels adopted in accordance with international standards). Pelephone's third party liability insurance policies do not presently cover liability for electromagnetic radiation.
- 3.25.2.6 Site licensing – the erection and operation of cellular antennas are subject to building permits from the various planning and building committees, a process that involves, inter alia, obtaining a number of approvals from Government entities and regulatory bodies. For details of the difficulties encountered by Pelephone in the erection and licensing of sites, see Section 3.18.3.3 above.

3.25.3 Pelephone's Risk Factors:

- 3.25.3.1 Terminal equipment quality – Pelephone might be exposed to losses in the event of malfunctions in the terminal equipment that it sells, including indirect damages that might be caused as a result of such malfunctions.
- 3.25.3.2 Property risks and liabilities – Pelephone is exposed to various property risks and liabilities. Pelephone employs the services of an expert external insurance consultant in this field. Pelephone has insurance policies which cover the usual risks to which Pelephone is exposed within the limits of the conditions of such policies, such as: Various forms of property insurance, various forms of liability insurance, loss of profits, third party liability insurance and office-bearers' insurance.
- 3.25.3.3 Serious malfunctions in information systems – Pelephone's information systems are networked throughout the country via designated communications lines and via the internet. Pelephone's business is highly dependent upon these systems. Large-scale malicious harm or malfunction might adversely affect Pelephone's business and results.
- 3.25.3.4 Serious malfunctions in the communications network – Pelephone's communications network is spread out around the country via network core sites and antenna sites. Pelephone's business is totally dependent upon these systems. Large-scale malicious harm or malfunction might adversely affect Pelephone's business and results.
- 3.25.3.5 Legal proceedings – Pelephone is party to legal proceedings, including class actions, which are liable to result in its being ordered to pay material amounts that cannot presently be estimated, and in respect of most of which no provision has been made in Pelephone's financial statements. Pelephone is exposed to class actions. Class actions may reach high amounts, since approximately one third of the residents of the State of Israel are Pelephone consumers, and a claim relating to a small amount of damage to a single consumer may grow into a material claim against Pelephone if recognized as a class action applicable to all or a large proportion of those consumers for legal proceedings to which Pelephone is a party.
- 3.25.3.6 Frequency restrictions and interruption of use in frequency bands – at present, the volume of vacant frequencies that can be allocated to Pelephone over and above the frequencies it has in the CDMA range is limited. The frequencies range used by Pelephone for operating the CDMA technology network is also used by land based television broadcasts, and part of the range is also used for cellular communications using GSM technology. Due to the use of those frequency ranges, broadcasts by a number of television stations transmitting in the Middle East cause disturbances in the operation of Pelephone's aforementioned network. In some cases, these disturbances have reached a level that prevents high quality CDMA-technology communication in parts of the Pelephone network. Likewise, in light of the peace agreement with Jordan, Pelephone is precluded from making use of part of the frequency range that is suitable for the CDMA network, since the Jordanians use it for the networks they operate using GSM technology. In addition, in the next few years, digital multi-channel television broadcasts are expected to evolve, transmitting a large number of compressed video channels, and this could aggravate the existing disturbances in the operation of Pelephone's CDMA network.

The following are the risk factors as described above, and their effect in the opinion of management, on the results of its business:

Effect of Risk Factor on all of Pelephone's Activity

Risk factors	Large	Medium	Small
Macro-economic risk factors:			
Recession		X	
Exposure to exchange rate and CPI fluctuations		X	
Industry-based risk factors:			
Investments in infrastructure and technological changes	X		
Customer credit			X
Regulatory developments	X		
Competition	X		
Electromagnetic radiation*			
Site licensing	X		
Pelephone's Risk Factors:			
Quality of terminal equipment		X	
Property risks and liabilities			X
Serious malfunctions in information systems	X		
Serious malfunctions in the communications network	X		
Legal proceedings		X	
Restrictions applicable to frequencies and disturbance in use of frequency range		X	

* Pelephone is unable to assess the degree of effect of this risk factor on its activity.

4. International Communications and Internet Services – Bezeq International Ltd. (“Bezeq International”)

4.1 General

4.1.1 Structure and changes in area of operations

Bezeq International, a wholly-owned subsidiary of the Company, provides direct dialing services to some 240 destinations throughout the world. The international telephone services provided by Bezeq International, similar to the services provided by the other competing international operators, are based mainly on the Company's domestic network and on the cellular networks in order to connect subscribers to the international switchboard.

In addition to the international call services (hereinafter: “Voice Services”), Bezeq International provides data communications services (hereinafter: “Data Services”) internet access services (ISP) (hereinafter: “Internet Services”), value-added services, telephony traffic routing services between foreign international communications suppliers and server and site hosting services (hereinafter: “Hosting Services”), and integration services under which Bezeq International's business customers are offered total communications solutions (which include Data Services, Hosting Services and technical maintenance and support services for networks) (hereinafter: “Integration Services”).

Data communications services provided by Bezeq International include point-to-point lines, frame relay, ISDN, ATM, virtual private networks, video conferencing facilities, and IP services.

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The Israeli communications market is regulated mainly by the Communications (Telecommunications and Broadcasts) Law, 5742 – 1982 (hereinafter: the “Communications Law”) (see Section 4.17 below).

4.1.2.1 General license

Bezeq International operates pursuant to a general license for the provision of international telecommunications services (hereinafter in this chapter: the “License”), which is in force until 2022. The provisions of the License regulate, *inter alia*, the method of setting the tariffs which Bezeq International charges for its services, updates thereto and the collection of payments therefor.

4.1.2.2 Application for a special domestic license

On May 16, 2006, Bezeq International submitted an application to the Ministry of Communications for a special general license for the provisions of domestic fixed-line telecommunications services. The grant of such a license under which, *inter alia*, domestic VOB services would be provided (which constitute the necessary portion of the mixture of products provided by internet service providers) will enable Bezeq International to continue providing its customers with inclusive communications solutions (of the kind that its competitors offer, some of which competitors have already received similar licenses) and to compete as an equal to them.

As at the date of this report, the Ministry of Communications has not yet made a decision regarding the above license application.

4.1.2.3 Special license to conduct marketing trial for provision of VOB services

On December 6, 2004, the Ministry of Communications granted Bezeq International a special license to conduct a marketing trial for the supply of domestic telephony services using voice over broadband (VOB) technology. Under the trial, Bezeq International was permitted to provide full VOB services for a fee, to a maximum number of 8,500 lines. The trial license was granted to Bezeq International for one year at first, and was extended from time to time, the last extension being until February 28, 2007. Following an application for an interim injunction in a petition filed by Bezeq International against the Minister of Communications and others, set out in section 4.19.4 below, the Ministry of

Communications gave notice to Bezeq International, on February 27, 2007, of extension of the force of the marketing test pending a ruling on the above petition.

4.1.2.4 Royalties

Pursuant to its License and the Telecommunications (Royalties) Regulations 5761-2001, Bezeq International pays the State of Israel royalties at an annual rate of 3.5%, on most of its revenues stemming from the provision of international call services and point-to-point lines, minus permitted expenses and except for revenues from the customers determined in said regulations.

In the past, Bezeq International conducted an investigation, as a result of which it emerged that the manner in which the royalties paid by Bezeq International had been calculated had been incorrect, and that in previous years its royalty payments had been too high. Bezeq International consequently updated its royalty payments. As at the date of publication of the periodic report, there is a dispute between Bezeq International and the Ministry of Communications regarding this update.

With respect to the royalty rate – in August 2006, the Ministries of Communications and Finance approved the Telecommunications (Royalties) (Amendment) Regulations 5766-2006 under which the rate of royalties was reduced from 3.5% to 3% as of January 2006. Likewise, the amendment provided that the rate of royalties would fall gradually so that in 2007, it would be 2.5%, in 2008 – 2%, in 2009 - 1.5% and as of January 1, 2010, the rate would be 1%. In this regard see also Section 2.16.3 above.

4.1.3 Principal entry and exit barriers

4.1.3.1 The principal entry barrier to the international calls market derives from the need to receive a license pursuant to the Communications Law and implementation of infrastructure investments which are affected by frequent technological changes. However, a change in the licensing policy, as will be described below, and expansion of the use of VoIP technology in this sector are leading to significant reductions in the effect of these barriers.

4.1.3.2 The principal entry barrier to the data and internet services market stems from the need for investments in infrastructure (international capacity and access to the internet network and a broad service setup).

4.1.3.3 The principal exit barriers from these markets stem from long-term binding agreements with suppliers and investments requiring long repayment periods. In addition, Bezeq International is obligated to provide service to its customers throughout the period of its agreement with them.

4.1.4 Alternatives to Bezeq International products

The international calls market contains service suppliers which are not licensees (illegal operations), and consequently are not subject to the restrictions imposed on Bezeq International by virtue of the License and the provisions of the law. In addition, the use of VoIP technology enables the transfer of international calls on the internet network to other users of this technology and also to users of the TDM networks, by means of software products and overseas communications suppliers. The attractive usage tariffs for these services are bringing about a steady increase in the number of users and this results in harm to the revenues of Bezeq International.

4.1.5 Structure of competition in the sector and changes therein

In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. In July 1997 two other international operators entered this arena: Barak I.T.C. (1995) - International Telecommunications Services Company Ltd. and 012 Golden Lines Ltd., and this led to a sharp fall in the prices of international calls and extensive growth in market volume. In April 2004 the Communications (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services) Regulations, 5764-2004 entered into effect. As at the date of publication of this report, the Ministry of Communications has granted general licenses for the provision of international telecommunications services to three more operators: Internet Gold-Kavei Zahav Ltd. (Internet Zahav), Netvision Ltd. and Xfone Communication Ltd., all of which

started operations by the end of 2004. The expansion of competition has led to an additional fall in the prices of international calls, although, unlike 1997 when competition began, the volume of international traffic did not undergo a significant increase, since prior to the expansion of competition, call prices did not constitute a factor preventing the public from using the service. The above-mentioned expansion of competition had a negative effect on the results of Bezeq International's operation and on its financial condition, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector.

As at the date of the periodic report, licenses for the provision of Internet Services have been granted to some 70 companies, among them five of the aforementioned international operator licensees.

In December 2004, the Ministry of Communications permitted Bezeq International to provide fixed line telephony services over its internet network (VOIP) to 8500 customers for a trial period of one year (which was extended to the end of August 2006).

On April 20, 2005 the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the licensing of the provision of telephony services by means of broadband access (VOB – Voice Over Broadband), in a way that will prevent Bezeq International (a subsidiary of the Company) from providing the service until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and in November 2007. This policy amendment, if adopted, is liable to oust Bezeq International from this developing market, thereby awarding its competitors in internet access and international dialing services (most of which have received marketing trial licenses from the Ministry of Communications for providing these services and some are already operating in accordance with it) a clear competitive advantage in that they will be able to offer their customers a total communications solution combining access to the Internet, international telephony and fixed-line domestic telephony services. On February 2, 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims regarding the entry of the aforementioned policy amendment. Following the hearing, on February 8, 2006, the Ministry of Communications published a notice of its intention to ease the limitation on Bezeq International and to permit it to act in the field of VOB, under certain restrictive conditions.

On January 31, 2007, the Minister of Communications decided to amend the policy of the Ministry of Communications regarding the licensing of VOB services, pursuant to which Bezeq International would only be granted a license to operate domestic land-line telephony services using VOB technology once the Company's share of the market for domestic land-line telephony was less than 85%. Following that decision, the Ministry of Communications granted 012 Golden Lines Ltd. a permanent license to provide VOB services as part of its special domestic license, and gave notice of its intention to grant similar licenses to other licensees. On February 5, 2007, Bezeq International filed a petition to the Supreme Court sitting as the High Court of Justice, to revoke the above decision of the Minister of Communications, as set out in section 4.19.4 below.

The inability of Bezeq International to offer a similar total solution in the event that, at the end of the day, it will not be allowed to provide VOB services, or substantial limitations are imposed upon it in this regard, might cause the departure of existing customers in favor of the services of competitors, and might give rise to difficulties in getting new customers. Bezeq International is unable, at this stage, to estimate the effects of churn as aforesaid on the results of its operations and its financial condition. In this regard see also Section 2.6.1 above.

Implementation of the numbering and number portability plan (see Section 2.6.6 above) might require Bezeq International to make additional investments in infrastructure and equipment. Bezeq International cannot, at this stage, estimate the total extent of such investments.

4.2 Products and Services

Below are details of the principal products and services provided by Bezeq International:

4.2.1 Voice Services

In the Voice Services sector Bezeq International provides: International Direct Dialing (IDD) services to business and private customers; toll-free number services for business customers overseas; telephone card services enabling prepaid and postpaid dialing, mainly from overseas to Israel, for business and private customers; broadband telephony services (VOIP) on the basis of an experimental marketing license; and the 1809 service enabling dialing from Israel to overseas by dialing 1809. For this, see also Section 2.6.1 above.

4.2.2 Internet Services

In the Internet Services sector Bezeq International provides: internet access services to private and business customers, including terminal equipment and support, with an emphasis on fast broadband internet based on ADSL or cable infrastructures; Hosting Services – site storage and server services in a designated installation for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' internet and LAN connections using the required terminal equipment or software, including monitoring; Data Services which include international data communication IP solutions for business customers, including global deployment if necessary; and wireless (WIFI) access – fast wireless access solutions for private and business customers, including in various public locations (hotspots).

4.2.3 Data Services

Provision of international data communication solutions for business customers, including global deployment in accordance with the customer's requirements.

4.2.4 Integration Services

During the third quarter of 2005, Bezeq International set up an Integration and New Business Department, whose operations shall focus on the fields of data, hosting (of servers and websites), and total integration solutions for businesses.

4.3 Revenues

Below are data of Bezeq International's revenues (in NIS millions):

	2006	2005	2004
Total Revenues	1,022	815	810
Percentage of gross profit	35%	35%	38%

4.4 New Products

Following are descriptions of the principal new products launched in 2006:

4.4.1 **“Supplier Portal” Service** (formerly a Bezeq Gold Service) – an electronic platform for following up orders and invoices between customers and suppliers.

4.4.2 **“Bank Flash” Service** (formerly a Bezeq Gold service) – which enables customers who work with a number of different banks to receive details of their account movements in a concentrated manner, directly to their accounts management.

4.4.3 **VMWARE** – which offers a virtual server that is stored and managed by Bezeq International (and not by the customer) in a format which enables a number of virtual server environments on one physical server.

4.4.4 **Managed Firewall services** – managed information security services stored and managed at Bezeq International rather than the customer – the customer has no need to manage the “box” on site.

4.4.5 **Service contract service** – which enables small and medium businesses to purchase hour banks or to pay per call for support and service in IT, networking and systems issues.

- 4.4.6 **Prepaid site** – a site for online sale of prepaid cards for calling overseas from Israel and for calling Israel from overseas, at attractive prices.
- 4.4.7 **Bigger inbox** for private customers – inbox increased to 1G.
- 4.4.8 **Safe net** – an antivirus service which protects against viruses and worms, etc.

4.5 Marketing, Distribution and Service

- 4.5.1 The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International –which are used by Bezeq International to remain in contact with the various advertising media (television, internet, radio and the daily national press) – production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies. Bezeq International believes that the loss of contact with any of its permanent advertising or marketing suppliers will have no significant effect on its marketing and distribution channels.
- 4.5.2 Bezeq International operates sales channels for the private market, as set out below:
 - 4.5.2.1 Recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files.
 - 4.5.2.2 Retention center for internet and incoming voice call services providing solutions for customers wishing to leave Bezeq International and retention center for internet and outgoing voice call services which handles existing customers proactively.
 - 4.5.2.3 National direct sales setup conducting “door to door” operations, operating points of sale and managing customers.
 - 4.5.2.4 Distribution channel setup including external centers and field systems for resellers and dealers.
 - 4.5.2.5 Yes@wow – a joint venture with DBS in which subscribers are recruited for integrated packages comprising internet access, multi-channel television, Company internet access infrastructure (for further details see also Section 5.16 below).
- 4.5.3 Bezeq International operates sales channels for the private market, as set out below:
 - 4.5.3.1 New customer recruitment center – for SMB customers under the ingoing and outgoing call model, using files.
 - 4.5.3.2 Increased existing customer volume center – for SMB customers under the ingoing and outgoing call model, using files.
 - 4.5.3.3 Customer portfolio retention center which handles the “heaviest” customers in the SMB sector, retains them and increases revenues from them. This center also acts as a second line regarding retention matters.
 - 4.5.3.4 National direct sales setup conducting “door to door” operations, operating distributors and recruiting SMB customers.
 - 4.5.3.5 A telemeeting center for setting and coordinating meetings with potential customers for SMB and SME customers.
 - 4.5.3.6 SME field which concentrates customer managers who recruit and manage medium-sized customers on an ongoing basis.
 - 4.5.3.7 ENT field which concentrates customer managers who recruit and manage strategic customers on an ongoing basis.

4.6 Competition

The main characteristic of competition in the market is the consolidation of the market, which includes the mergers of Barak / Netvision, Golden Lines / Internet Zahav and on the other hand, the merger of Bezeq International with BezeqCall.

The domestic carrier is a new issue with customers and will allow for the drafting of agreements with customers with respect to connections to the internet and international calls.

The competition, which is characterized by a trend of erosion of tariffs, is expected to continue to fall towards the second half of 2007.

4.6.1 Voice Services

4.6.1.1 In 2006 there were six competitors operating in the market: 014 Bezeq International, 013 Barak, 012 Golden Lines, Internet Zahav, 017 Netvision and 018 Xfone.

Some of these companies are in the process of merging. When the mergers take effect, there will be four competitors left on the market: Bezeq International, the Barak-Netvision Group, the Internet Zahav Golden Lines Group, and Xfone. In 2007, each of the merged companies will still operate two dial codes. Unification of the codes 013+017 and 012+015 will take place in fact in 2008.

In Bezeq International's estimation, its market share in the area of these services is 32%.

4.6.1.2 General characteristics of competition in 2006:

4.6.1.2.1 About 50% of households make international calls at least once a month.

4.6.1.2.2 The various sectors are extremely important (emphasis on immigrants originating from the former USSR) and marketing operations are designed accordingly.

4.6.1.2.3 The product is a commodity.

4.6.1.2.4 The market is a price market (perception).

4.6.1.2.5 Lack of involvement from consumers, leads to difficulty in recruitment and customer loyalty retention owing to inertia.

4.6.1.3 The multitude of competitors and the penetration of VoIP technology increases competition. This increased competition is expressed in ever decreasing prices and profit erosion.

4.6.2 Internet Services

4.6.2.1 This market has five significant competitors: 014 Bezeq International (estimated market share 36%), Netvision (estimated market share 21%), Internet Zahav (estimated market share 16%), 012 Golden Lines (estimated market share 16%), and 013 Barak (estimated market share 11%).

4.6.2.2 When the aforesaid mergers take effect, there will be three significant competitors in the market: Bezeq International, the Barak-Netvision Group, and the Internet Zahav Golden Lines Group.

4.6.2.3 General characteristics of competition in 2006:

4.6.2.3.1 72% of Israeli households are connected to the internet (95% of them have high-speed connections).

4.6.2.3.2 ADSL is the leading infrastructure (64% of high-speed internet connections)

4.6.2.4 Developments in 2006:

4.6.2.4.1 Continued slow-down in rate of growth of high-speed internet compared with previous years. This requires that a focus be placed on retention of customers and recruitment of customers from competitors.

- 4.6.2.4.2 Continued transition of customers to higher speeds as a result of the launch of 2.5 M speeds in March 2006, and of encouragement of telecommunications and cable infrastructure providers and internet service providers.
- 4.6.2.4.3 The issue of price will continue to be critical in recruiting customers and the trend of transition from an emphasis on low prices to an emphasis on high speeds, service and bundles will continue, and the offers of an internet package with VoIP or packages containing content will expand.
- 4.6.2.4.4 Strengthening of the trend of selling bundle and triple packages in the market.

4.6.1. **Solutions for the business sector – Bezeq International business**

Characteristics of the business arena in 2006

Viewing the customer as the center and with the desire of increasing revenues from business customers, Bezeq International started supplying integration services to businesses in 2006, providing full solutions in areas such as system, networking, IT, hosting, voice, data, ISP, wireless, etc.

The solution is that of a full solution model for the customer, without relying on external suppliers, the customer getting a single contact person and which full responsibility for the process (one supplier. One responsibility).

With the commencement of provision of integration solutions, Bezeq International is dealing with new competitors in this field, such as Binat, Teldor, IBM, and others.

The rest of the companies that are in competition with Bezeq International, and which, together with the Bezeq Group, fall into two main communications groups, are also trying to reinforce this field and competition is expected from that direction as well: The expectation is that Internet Zahav will reinforce its integration solutions in the merged company, and that Netvision will also continue to do so.

4.7 Seasonality

In general, the revenues and profitability of Bezeq International are affected in a minor way by the seasons of the year and holidays. There are seasonal fluctuations in the following services:

- 4.7.1 Voice Services for the business sector – decrease in August and the Passover / Tabernacle holidays.
- 4.7.2 Voice Services for the private sector – increase in the summer months and towards the end of the civil year.
- 4.7.3 Internet services – the best results are usually obtained in the fourth quarter, whilst in April-June, recruitment figures are usually lower.
- 4.7.4 Internet services for the business sector – decrease in the summer months owing to the closure of educational institutions (customers in this sector are not billed for the Internet Services to which they subscribe in the summer vacation months).

4.8 Property Plant & Equipment

- 4.8.1 In the periodic report for 2005, Bezeq International referred to international communications infrastructure (underwater cables and international switches) which Bezeq International leases (mainly from Mediterranean Nautilus Limited) as plant and equipment. Upon adoption of IFRS, these Bezeq International rights in international infrastructure can no longer be regarded as plant and equipment. For reference to Bezeq International's contract with the infrastructure supplier Mediterranean Nautilus, see section 4.11.5 below.
- 4.8.2 Towards the end of 2004, Bezeq International signed an agreement with Veraz, to purchase SoftSwitch switches which, during the course of 2005, replaced the Alcatel S-12 voice switches (which, at this stage, are still being used as a non-substantial component in the Company's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on

an Intelligent Network (IN), which were also replaced in 2005 as part of the upgrade of its voice setup.

Bezeq International's technological infrastructures which support the voice, data and internet setups are deployed in four sites in order to provide services with high survival. During the course of 2005, Bezeq International set up another site in London, England, via which advanced services are provided to its customers.

Bezeq International has long-term agreements for the lease of the main structures in which it is based, for average periods of 6 years.

- 4.8.3** 4.8.3 On November 14, 2006, Bezeq International signed an agreement with Avnet Choshen Building and Investment Company Ltd. for lease of an area of approximately 7,000 sqm for a period of 8 years and four months, expected to commence in April 2007, and to terminate in July 2015, with an option to extend the lease term for two years each time, and up to an additional 8 years.

4.9 Intangible assets

4.9.1 License for the provision of Bezeq International services

Bezeq International operates within the framework of a general license for the provision of international telecommunications services, pursuant to the Communication Law, which anchors the right of Bezeq International to provide Internet Services. The license constitutes the basis for Bezeq International's operations.

4.9.2 Acquisition of operations of Goldnet Communications Services (Bezeq Gold)

On April 30, 2006, Bezeq International signed an agreement with Malam Systems Ltd. (hereinafter: Malam) and the Company to purchase all of the operations done by Goldnet Communications Services (hereinafter: Goldnet), a registered partnership held by Malam (25%) and the Company (75%), which provides solutions for secure distribution and transfer of information electronically between organizations, in consideration for the total sum of NIS 6.8 million which should be paid to Goldnet. As part of the acquisition, all of the agreements between Goldnet and its customers and suppliers, and franchise agreements and joint venture agreements to which it was a party were assigned to Bezeq International, and all of the intellectual property, inventory and/or property, plant and equipment of Goldnet were transferred to it as well.

Once all of the preconditions set out in the acquisition agreement had been fulfilled, Goldnet, which had run its business under the trade name "Bezeq Gold", ceased to provide services. However, for a period of 12 months following the date of completion of the acquisition transaction, Goldnet will continue its contracts with customers under those agreements which could not be assigned to Bezeq International, and will transfer all of its receipts from such to Bezeq International. On June 30, 2006, Goldnet fired most of its employees and paid them all of the moneys that they were entitled to for termination of their employment. The majority of them were taken into to various positions at Bezeq International, in accordance with the provisions of the agreement.

After execution of the agreement, a supplier of services to Goldnet exercised its right to refuse assignment of its contract with Goldnet to Bezeq International. Bezeq International reached an agreement with the supplier under which it sold the supplier the right to continue contracting with existing customers of Goldnet for the services that it provided, subject to payment of consideration by the supplier, which does not harm the feasibility of the transaction.

4.9.3 Acquisition of Actcom Active Communications Ltd.

On December 13, 2006, Bezeq International executed a transaction to acquire 100% of the shares of Actcom Active Communications Ltd., the oldest supplier of internet access services in Israel, from its two founders. Actcom, whose offices are in Haifa, shall continue to run its business as an independent subsidiary of Bezeq International.

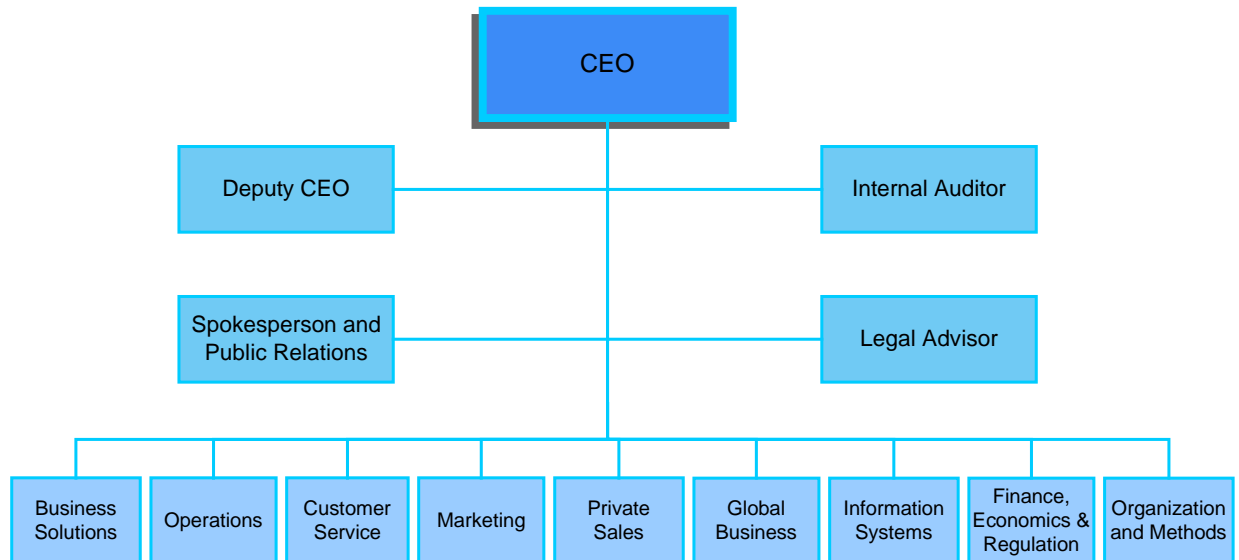
For the merger of Bezeq International's operations with BezeqCall Communications Ltd. (a wholly owned subsidiary of Bezeq which deals in the field of network end points) see update to section 1.1.5 above.

4.10 Human Resources

4.10.1 The number of persons employed by Bezeq International (employees of the Company, employees of human resources firms or outsourced) is 1,951, of whom: 510 are HQ staff (management, finances and human resources, marketing, information technology, operations, global business and business solutions), and 1,019 are service and sales staff.

4.10.2 Organizational structure

Below is a chart depicting the organizational structure of Bezeq International:



4.10.3 Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives: sales employees, telephone sales representatives and telephone service and support representatives.

4.10.4 Employees have a leasing arrangement enabling employees to receive vehicles at a cost determined in accordance with the terms of an agreement between Bezeq International and a leasing company.

4.10.5 Bezeq International invests resources in professional training in accordance with the type of employee and the field in which he or she operates, such as: management reserve given to department managers and professional staff, negotiations and mediation, systems analysis, management skills, etc.

4.10.6 All of Bezeq International's employees have standard personal contracts based on their professions and positions.

4.11 Accounts Payable

4.11.1 In February 2005 Bezeq International signed an agreement with SigValue for the purchase of an intelligent network system, the cost of which is not material. Bezeq International will be dependent on this provider.

4.11.2 Bezeq International has an agreement with Tadiran Information Systems Ltd. (which was acquired by IBM) which is implemented by IBM Global Services (Israel) Ltd. (hereinafter: "IBM") for the maintenance and development of service absorption and pricing and billing systems. Bezeq International is dependent on this service from IBM.

4.11.3 In 2004 Bezeq International set up a contact center (a system which integrates switchboard, a collaborative system comprising computer, switchboard and interactive voice response). This setup is used by Bezeq International's service, support and sales centers, and is based on the Avaya company technology. For this purpose Bezeq International signed a three-year agreement with IBM to provide ongoing support and maintenance.

4.11.4 Bezeq International has financial relations with some 100 foreign operators, in approximately 240 destinations worldwide. The substantial foreign carriers in terms of size

and cost of traffic passing through them are: British Telecom, Rostelecom, Paltel, AT&T, etc.

- 4.11.5** Bezeq International is dependent upon the international communications infrastructure provider Mediterranean Nautilus Limited, which supplies it with most of the international communications infrastructure that it requires via a submarine cable operated by it from Israel to Europe. From there onwards, Bezeq International makes use of other infrastructure for the purpose of connecting to the rest of the world.

4.12 Working capital

- 4.12.1** Bezeq International's cash item includes bank deposits for immediate withdrawal as well as fixed-term deposits on which there are no usage restrictions and whose repayment date, on their investment date, does not exceed three months.

- 4.12.2** 4.12.2 Bezeq International has surplus current liabilities over current foreign currency assets stemming from Bezeq International's contracts with foreign international communications carriers for the transmission of voice minutes and the purchase of data services (see Section 4.21A) which were significantly reduced in 2006 as a result of Bezeq International's operations to close old accounts with them, and this considerably improved the deficit in net balances. As at the end of 2005 and 2006, Bezeq International has positive working capital.

Bezeq International's expenses for foreign international communication operators are based on estimates of business volumes. The balance of the overseas operators includes adjusted estimates and assessments of costs in connection with those overseas operators. The source of these adjustments and estimates is the final accounting for the period in question.

4.13 Credit policies

4.13.1 Credit to customers

4.13.1.1 Most of Bezeq International's customers have credit terms of EOM + 45.

4.13.1.2 Equipment sold to customers is usually billed in 24 installments.

4.13.2 Credit from suppliers

Bezeq International receives credit from its suppliers for a period ranging from 30 to 120 days (usually 90 days).

4.14 Investments

As at December 31, 2006, Bezeq International held 44.04% (33.66% under full dilution as at 2006) of the share capital of Walla! Communications Ltd. (hereinafter: "Walla"), an Israeli company whose shares are listed on the Tel Aviv Stock Exchange, which provides Internet Services and is an internet portal provider. During the course of 2006, Bezeq International and others exercised option warrants of Walla! (series 3). In all, Bezeq International exercised 2,564,764 option warrants (series 3) in 2006, in consideration for a total sum of NIS 4,617,000, which was set off against the balance of the shareholders' loans provided by Bezeq International to Walla! Following exercise of the option warrants, the Company has a cost surplus in the sum of NIS 2,313,000, which was ascribed to fair value of intangible assets based on purchase price allocation (PPA) work done by an external appraiser.

After the balance sheet date, and prior to the date of publication of this periodic report, as a result of exercise of additional option warrants (series 3) by other persons, the rate of Bezeq International's holdings of Walla! fell to 42.57% (33.66% fully diluted). The balance of Bezeq International's investment as at 2006 amounted to NIS 32.1 million, while its market value amounted to approximately NIS 125.8 million.

Walla! concluded 2005 with a net profit of approximately NIS 12.3 million and 2006 with a net profit of approximately NIS 25.5 million.

For additional details regarding Bezeq International's investment in Walla, see Note 12 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

Moreover, since November 2003, Walla's reports to the Israeli public can be found on the Securities Authority's Magna website.

4.15 Financing

4.15.1 As at the date of publication of this report, the Company has no liabilities to banking institutions and is not utilizing its approved line of credit.

4.15.2 A floating charge which was registered in the past in favor of banking corporations, stating that Bezeq International cannot charge its assets without consent, was removed on December 12, 2006.

4.15.3 The source of Bezeq International's finance in the past two years has been a positive cash flow from current operations.

Loans from the Company – during 2001 Bezeq International received from the Company non-interest-bearing, CPI-linked loans totaling \$ 38 million the sum of which, on Bezeq International's balance sheet as at December 31 2005 and 2004 amounted to approximately NIS 113 million and NIS 169 million, respectively.

On February 1, 2006, having received the approval of management of Bezeq International that Bezeq International is able to repay the loan without such harming the running of its business, the board of directors of Bezeq International resolved to bring forward the date of repayment of the loan and to pay the sum of the loan, linked to the CPI, back to the Company on February 14, 2006 – in all, the sum of approximately NIS 173 million.

4.15.4 Bank guarantees – in accordance with the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee in the sum of NIS 9.4 million and NIS 1.4 million to fulfill all of the conditions of the license for provision of international telecommunications services; in December 2004, in accordance with the requirements of the Ministry of Communications, Bezeq International gave a bank guarantee in the sum of approximately NIS 340,000 for fulfillment of the conditions of the special license given to it to conduct a marketing trial for the provision of VOB services. As at the balance sheet date, Bezeq International has provided additional bank guarantees in a total sum of approximately NIS 3.2 million.

4.16 Taxation

See Note 8 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

4.17 Restrictions on and Supervision of Bezeq International's Operations

4.17.1 Legislative restrictions

4.17.1.1 The Communications (Telecommunications and Broadcasts) Law, 5742-1982 and the general license for the provision of international telecommunications services.

Under the Communications Law, the implementation of telecommunications operations and provision of telecommunications services, including international telecommunications services and internet access services, require a license from the Minister of Communications. The minister is authorized to amend the terms of the license, add to them or detract from them, while taking into consideration, *inter alia*, the government's telecommunications policy, the interests of the public, the matching of the licensee to the provision of services, the contribution of the license to competition in the telecommunications industry and the level of service therein.

The Law authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms.

A recently introduced amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe those telecommunications services, the provision of which does not require a license. Pursuant to his

declarations, the Ministry of Communications intends to exempt the provision of internet access services.

In view of said provisions of the Communications Law, all Bezeq International's telecommunications services are provided by virtue of the provisions of the licenses granted to it and pursuant to the terms of them, as set forth in Section 4.1.2 above.

4.17.1.2 Interconnectivity payments

The Telecommunications (Payments for Interconnect) Regulations, 5760-2000 (hereinafter: the "Regulations") regulate the payments made to the domestic operator or the cellular operator.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for completion of a call will be reduced from March 1, 2008 to a maximum tariff of NIS 0.22.

The above-mentioned tariffs, rounded to 12 seconds, will be updated from March 1, 2006 in accordance with the percentage of the change in the CPI.

4.17.1.3 Royalties

For payment of royalties, see sections 4.1.2.4 and 2.16.3 above.

4.17.1.4 Standards

Bezeq International is ISO 9001:2000 certified for quality management systems and ISO 7799 certified for information security management systems by the Israel Standards Institute.

4.18 Joint venture agreements

4.18.1 In April 1997 Bezeq International signed an agreement with the communications corporation Concert for the sale of data transfer services via Concert. The corporation was set up by British Telecom (BT) and the American company AT&T and also provides uniform communications services to multinational companies. During the course of 2002, the corporation wound up and the network is currently managed by BT. Bezeq International has an agreement for the distribution of BT's services in Israel, under which Bezeq International supplies FR technology managed network services, and IP based services.

4.18.2 In June 2003 Bezeq International signed an agreement with Infonet Corporation (hereinafter: "Infonet") for the distribution of Infonet's data communications services. Infonet is a network connecting many sites worldwide and provides for the efficient transfer of data between these sites. In December 2003 an agreement was signed by Bezeq International and Kardan Communications Ltd. for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International which received the equipment and rights to provide Infonet services in Israel, and it will provide technical support to all Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services.

During the first quarter of 2005, Infonet was acquired by BT, as a result of which a restructuring took place under which the infrastructure used by the companies to provide their services to Israel was unified. At this stage, neither the acquisition or the restructuring have had any effect on the running of Bezeq International's business, nor on the sale by it of Infonet products.

4.19 Legal proceedings

4.19.1 In April 2004 a competing international communications operator filed a claim in the Jerusalem District Court against the State of Israel in the amount of NIS 11.2 million, for damages allegedly caused to it by a violation by the State of Israel of an obligation to place at its disposal part of the total capacity of an underwater cable (which was granted as part

of the tender which opened the international communications market to competition in 1995).

In September 2004 the State of Israel filed a statement of defense and third-party notice against Bezeq International and the Company.

Following negotiations between the parties out of court, they reached a settlement which is currently in the process of being signed. The Company's and Bezeq International's obligations under the settlement are to pay sums that are not substantial.

- 4.19.2** In January 2005 a claim was filed in the District Court at Tel Aviv against Bezeq International, against two other international operators and against another company, in the amount of NIS 10 million, based on the argument that a patent for a prepaid telephone system had been infringed by persons alleging that they are the inventors and owners of said patent. According to the plaintiffs each of the defendants is infringing the patent which they own and unlawfully enriching themselves at their expense. In the statement of claim the plaintiffs demand that detailed reports of said revenues stemming from the infringement of the patent be submitted to them and that said full revenues, plus reasonable royalties and punitive compensation, be paid to them pursuant to the provisions of the Patents Law.

In April 2005, Alcatel took over management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel is standing in lieu of Tadiran for the purpose of this agreement).

- 4.19.3** In May 2006, Bezeq International filed an appeal with the Local Court at Tel Aviv, against a decision of the Ministry of Communications to impose a monetary sanction on the company in the sum of approximately NIS 1 million for prima facie breach of the provisions of its license regarding erotic services;

In January 2007, the court upheld the appeal in part, and the Ministry of Communications was required to refund Bezeq International the sum of NIS 387,000. Bezeq International filed an application for leave to appeal to the District Court at Tel Aviv where it petitioned for refund of the rest of the sanction paid by it.

- 4.19.4** In February 2007, Bezeq International filed a petition with the Supreme Court sitting as the High Court of Justice, to cancel a decision of the Minister of Communications made on January 31, 2007, to amend the policy of the Ministry of Communications regarding licensing of VOB services – under which decision, Bezeq International would only be given a license to operate domestic land line telephony services using VOB technology after the Company's market share in the field of domestic land-line telephony had fallen below 85%.

- 4.19.5** 4.19.5 For further updates on legal proceedings, see Notes 15 and 17 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

4.20 Goals, Business Strategy and Expected Development

- 4.20.1** As part of the preparations for 2006, Bezeq International set itself a number of key goals outlining the nature of its operations and reflecting the strategy which it adopted during the year:

4.20.1.1 Retention of Bezeq International's Profits.

4.20.1.2 Readiness for mergers in the industry and turning threat into opportunity.

4.20.1.3 Retention of Bezeq International's leadership status via market share or leading margin.

4.20.1.4 Progress on existing customer base, with emphasis on more efficient management of the churn prevention process.

4.20.1.5 Streamlining of customer service system and improving Bezeq International's concept of service.

4.20.2 Bezeq International's goals for 2007

4.20.2.1 Retaining leadership in the ISP field.

- 4.20.2.2 A quality merger process with BezeqCall at the employee, processes and customer levels, effecting merger synergy.
- 4.20.2.3 Creating loyalty by improving customer satisfaction and experience.
- 4.20.2.4 To continue being a focal point for excellent employees.
- 4.20.2.5 Improvement of effectiveness and efficiency of cross-organizational work processes.
- 4.20.2.6 Timing of investments as a tool for retaining the stability and growth of Bezeq International.
- 4.20.3** 2006 was characterized by continued growth and increases in Bezeq International's revenues and operating profits.
- 4.20.4** In 2006, Bezeq International increased the variety of communications solutions that it provides to its commercial customers. During the course of the year, Bezeq International merged with Bezeq Gold and completed all of the proceedings for the merger with BezeqCall. Bezeq International views this field as having growth potential and plans to ground its status in this area even more.
- 4.20.5** 2006 was characterized by a continued increase of Bezeq International's operations in the field of supply of internet access services in general, and broadband internet in particular, including a variety of value added services and Datacom operations to international customers; in this way, Bezeq International continued to reduce its reliance on revenues from international outgoing call services.
- 4.20.6** In 2006 Bezeq International improved its market position in all the areas of its operations. This year, Bezeq International grew significantly in the field of international businesses in which it operates.
- 4.20.7** During 2006, Bezeq International completed upgrading its core network. This upgrade enables the Company to offer its customers high-speed and high-quality services.
- 4.20.8** In 2006, Bezeq International continued to invest in its customer service system, which provides service and technical support to its business and private customers. Following this improvement in its customer services, there was an improvement in 6 out of 9 of the indices included in the Globes service index, and after total weighting, Bezeq International is ranked first on par with Netvision.
- 4.20.9** The above information is forward-looking and as such is not certain and might not become reality, in whole or in part. The forward-looking information is based on information that Bezeq International currently has as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results are likely to be materially different from the results estimated or inferred from this information.

Management's forecast is based on forecasts related to the continued recovery in the Israeli market, continued penetration of broadband technology and continued growth in the number of internet users.

The above forecast might not become reality at all or might become reality in part only, owing to a downturn in the Israeli economy which will reduce purchasing power in Israel, owing to regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and owing to all the other risk factors listed below.

4.21 Risk factors

Changes in exchange rates, CPI and interest rates

- A Changes in exchange rates – the main currency used by Bezeq International is the shekel which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from Israeli customers. In addition, Bezeq International provides services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. In contrast, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. The changes in the exchange rates of the

currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its cash flow. To protect itself against currency exposure Bezeq International enters into hedging transactions and purchases other financial instruments.

- B. Competition – for the effect of the competition on the businesses of Bezeq International, see Section 4.6. above.
- C. Investments in infrastructures, technological changes and dependence on suppliers – see Section 4.11 above.
- D. Government oversight and regulation – for the application of the provisions of the Law and licensing policy and their effect on Bezeq International, see Sections 4.1.2 and 4.1.3.1 above.
- E. Legal proceedings

Bezeq International is a party to legal proceedings including class actions which might result in its being required to pay substantial sums and in respect of those for which the company's legal counsel has assessed that it might be necessary to make use of Bezeq International's financial resources, a provision has been made in Bezeq International's financial statements as well as in those of the Company. For legal proceedings to which Bezeq International is a party, see Section 4.19 above.

Risk Factor Summary Table

	Effect of Risk Factor on Bezeq International's Activity		
	Large effect	Medium effect	Small effect
Macro risks			
Exposure to changes in exchange rates		X	
Sector Risks			
Increasing competition	X		
Investments in infrastructure and technological changes		X	
Government supervision and regulation	X		
Special risks for Bezeq International			
Exposure in legal proceedings		X	
Dependence on suppliers			X

5. Multi-channel television – D.B.S. Satellite Services (1999) Ltd. (“DBS”)

5.1 General Information on Area of Operations

DBS, known also by the trading name of “yes”, provides multi-channel broadcast services to subscribers via satellite. DBS was founded on December 2, 1998, and has been providing this service since July 2000.

This service allows for the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via small antenna dishes from which broadcasts are transmitted to a domestic decoder in the subscriber’s home and connected to the television set.

Most of DBS’s income stems from subscription fees and additional payments made by viewers.

As at December 31, 2006, DBS had 539,558 subscribers.

DBS is the only company currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure and changes in area of operations

The area of broadcasts is regulated and operations in the area are effected via various broadcast licenses. The heavy regulation of the field of broadcasting includes the obligation to receive a license, the obligation to operate in accordance with the relevant provisions of the Communications Law, the provisions of the various licenses and the conditions thereof, and constant supervision of the Ministry of Communications and the Council.

Multi-channel television broadcasts have been offered in Israel since the mid-1990s, via companies which supplied cable television broadcasts. Those companies operated first under regional franchises on conditions of exclusivity, which were granted to them, and since 2002 they operated by virtue of long-term broadcast licenses which replaced the franchises. In November 1999, these companies were declared to have a monopoly in the field of multi-channel television broadcasts in the areas of the franchises in which they operated at the time, by virtue of the Antitrust Law, 5748-1988. As of the end of 2003, the cable corporations worked jointly in a number of areas of operations, under the brand name HOT. In December 2006, the cable corporations merged into a single merged cable company, HOT Cable Communications Systems Ltd., which supplies television services by cable to all of the subscribers of the cable corporations that were merged into it (the “**Cable Company**”). The Cable Company holds all of the rights in a limited partnership which owns the cable network infrastructure, including the terminal equipment and broadcast centers, and which, to the best of DBS’s knowledge, provides communications services, internet access and telephony services.

To the best of DBS’s knowledge, in 2006, the Cable Company purchased the operations of Cable-Tek Ltd., which operated in certain parts of Judea and Samaria in which Israeli law applies, as a cable broadcast corporation, which purchased the broadcast signal from the Cable Company and sells broadcasts to the residents of those areas on behalf of the local councils, which hold licenses to supply such broadcasts from the Civil Administration.

Following a government decision in August 2005 regarding the free distribution of certain television channels via a party which is to set up and operate a digital terrestrial broadcast system backed-up by satellite, hearing proceedings took place in 2006 prior to publication of a tender to set up and operate such system (see section 1.3 below).

During the course of 2006, the Ministry of Finance worked towards publication of a tender for the set-up and operation of a system for terrestrial distribution of digital radio broadcasts. As at the date of publication of this periodic report, the tender has not yet been published.

5.1.2 Statutory restrictions and special constraints

The Communications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license by virtue of the provisions of the law and pursuant to the Telecommunications (Proceedings and Conditions for the Grant of a Satellite Broadcasting License) Regulations 5758-1998 (hereinafter: the “**Broadcast License**”).

The broadcast license granted to DBS is in force until 2014. After the end of that period, the broadcast license shall be renewable for additional periods of six years each.

For additional licenses granted to DBS, see Section 5.8.1 below.

Operations in the field of broadcasting are subject to licensing and supervision by the Ministry of Communications, in aspects defined in the Law and the broadcast licenses (which relate, mainly, to matters relating to competition, consumers, and technical and engineering aspects). Operations in this field are also subject to the Ministry of Communications policy in various areas, which relate to or connect with DBS's current operations and fields in which it wishes to act, and which often have substantial effects on the operations of persons active in the field of broadcasting.

DBS' and the Cable Company's broadcasting operations are also under the constant supervision of the Cable and Satellite Broadcast Council (hereinafter: the "Council"). The Council sets policy and makes rules regarding the content of broadcasts, the duty regarding original Israeli productions, the division of content into genres, broadcasting ethics, consumer protection and other matters in the area of broadcasting policy. The Council is also responsible for enforcing the various statutes relating to the field of broadcasting, for approving the channels that DBS wishes to broadcast, or to cease broadcasting, and is also authorized to amend the broadcast licenses of DBS and the Cable Company under the conditions set out therein.

The Council has authority in the field of consumer protection, so that the setting of price lists, updating of price lists and offers to customers require its consent or the giving of prior notice (on the issue of DBS's activities being subject to legislation and to the supervision of the Ministry of Communications and the Council, see also section 5.14 below).

Changes may be made to the identity and nature of the persons supervising the operations of the players in the field of licensing and supervision of the field of broadcasting (including DBS's operations), at the initiative of the government, as follows:

- A. On October 30, 2005, the government decided to unify the operations of the Council, the Council of the Second Authority for Television and Radio, the Second Authority for Television and Radio and the Public Broadcasts Regulation Board (which provides professional and legal services to the Council) into a single unified commercial broadcasting authority, which is to be responsible for the regulation of all commercial television and radio broadcasts in Israel. To the best of DBS's knowledge, a government Bill has been prepared which is supposed to regulate this matter, however, it has not yet been submitted for voting in the Knesset plenum.
- B. To the best of DBS's knowledge, for several years, the government has been looking into setting up a communications authority, which is to replace the Ministry of Communications and the authorities referred to in section A above and which is to hold all of their powers, instead of the change planned as set out in section A above.

5.1.3 Developments in markets in the area of operations

- A. In 2006, the trend has increased to offer consumers a "total bundle of services" which includes, in addition to multi-channel television services, internet connection infrastructure (at high speeds) as well as fixed-line telephony services (a bundle which contains these three services is also called "triple play"), and there is increasing demand for purchase of such communications service bundles.
- B. In August 2005, the government decided to require the Minister of Communications and the Minister of Finance to do all of the acts required such that no later than January 1, 2007, the television channels of the Israel Broadcasting Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) would be distributed to the public freely, nationwide, via a terrestrial transmission service using digital technology, backed-up by a digital satellite system. Under the above decision, various governmental authorities were required to promote and implement the decision, and in that respect, to publish a tender to choose a person to plan, set-up and operate the digital terrestrial broadcast system, and the digital satellite distribution system. DBS gave its objection to the proposal to the Minister of Finance and the Minister of Communications, as well as its objections in the event that it is realized in any event. To the best of DBS's knowledge, as at the date of these statements, the Ministry of Finance is getting ready to hold a tender to select a party to set up and operate a system to distribution channels, DBS having been told that the tender outline will take its objections into account. If the government decision set out in this paragraph is

implemented, the broadcasts of such channels shall be a partially alternative product to DBS's broadcasts.

- C. In addition, in August 2005, the government resolved to require the Minister of Communications and the Minister of Finance to do all of the acts required in order to enable the public, no later than January 1, 2007, to purchase a basic television services package from the multi-channel television companies (the cable and satellite companies) including connection to the distribution infrastructure of DBS's broadcasts, and reception of the television channels of the Broadcast Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10), the Knesset Channel (Channel 99), the Educational Channel (Channel 23) and the designated channels, without the consumer being required to purchase any other services from the multi-channel television companies. To the best of DBS's knowledge, statutory amendments relating to implementation of the aforesaid decision have been integrated into the Arrangements Law 2006. DBS wrote to the Ministry of Finance asking to hold a hearing in the matter and as at the date of publication of this report, DBS is holding negotiations with the Ministry of Finance in this regard. As at the date of this report, to the best of DBS's knowledge, handling of the part of the bill relating to the basic service package has been separated from the Arrangements Law and is not being promoted.

In DBS's estimation, exercise of any of the above government decisions might harm DBS's revenues.

5.1.4 Technological changes that significantly impact on the area of activity

- 5.1.4.1 Technological developments and changes which have taken place in the field of digital broadcasting currently enable the provision of "personal television" services, which include bi-directional services that enable reciprocal communications between the individual subscriber and the service provider, and immediate provision of the service individually selected by the subscriber. The principal service in this field at present (even in Israel) is the provision of television services upon the immediate demand of subscribers, also known as Video on Demand (hereinafter: "VOD services"). As at the date of this report, VOD services are only provided by the Cable Company and this has a substantial effect on competition in the field of broadcasting (in this regard, see Section 5.6.5F below).
- 5.1.4.2 Around the world, video over broadband content transfer services have started developing, whether in closed systems or over the internet, and these are known as IPTV (Internet Protocol Television). These services and abilities enable the consumer to watch video content (either by transferring content to all users or by transferring individually upon demand), the content sometimes being viewed via a personal computer and at other times via the television. In Israel, this service has not yet been developed in a closed network, and broadband infrastructure owners might act to launch such services in the future, and entry of another service provider into this field might adversely affect the players in the field of broadcasts. However, as at the date of this report, video content is being transferred over the internet (in both local sites designed for Israel audiences and foreign sites), and the development of this trend might substantially affect the field of broadcasts, which is currently based on special infrastructure, and might enable the supply of varied video content without needing a special infrastructure system.
- 5.1.4.3 Use of decoders which are able to record content broadcast on various channels onto a hard disk, known as personal video records (hereinafter: "PVRs"). The PVRs sold by DBS interface with DBS's electronic broadcasting timetable and enable the receipt of special services regarding the content that is broadcast, including ordering recordings in advance, recording series and suspending live broadcasts. DBS provides its subscribers with PVR decoders known by the brand name of "yesMax". Launch of PVRs to DBS subscribers is, in DBS's assessment, a partial response to the lack of VOD services to the DBS's subscribers.

5.1.5 Critical success factors in the area of operations and changes therein

DBS regards the following factors as critical to the success of its operations:

- 5.1.5.1 Differentiation, innovation and originality in the content, branding and packaging of its broadcasts compared with the broadcasting content of its competitor, the Cable Company. These factors are reflected in the purchase and production of

content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the initiation, production and purchase of original Israeli programming. For such purpose, ongoing investment is required in the area of purchase and innovation of the content of broadcast supplied to DBS customers.

- 5.1.5.2 The ability to offer subscribers “personal” television services, and in particular, VOD services. This ability depends on the obtaining of regulatory consents and the amendment of legislation, and reaching a commercial agreement with Bezeq, including upgrade of Bezeq’s infrastructure (see section 5.6.5F below).
- 5.1.5.3 The ability to offer a bundle of communications services including television services and other services such as telephone services and internet services.
- 5.1.5.4 Differentiation at the customer service level provided to DBS subscribers by the customer support and customer service setup, which constitutes a critical success factor in DBS’ ability to retain customers in a competitive market.

5.1.6 Principal entry and exit barriers

- 5.1.6.1 The main entry barriers into the area of operations are: (a) the need for appropriate licenses under the Communications Law; (b) the immense investments required to be made by carriers in the area of operations, including for the purpose of setting up appropriate infrastructure and purchasing and producing content; (c) saturation of the broadcast market.

Recently, some of these entry barriers have begun to be eroded as a result of technological developments which enable the transfer of content over internet infrastructure (such as IPTV – see section 5.1.4.2 above).

- 5.1.6.2 The principal exit barriers are: (a) the regulatory barrier – termination of operations under the broadcast license depends on a decision of the Minister of Communications to cancel the license prior to the end of the license term, under the conditions set out in the license, including arrangements for ensuring the continuation of broadcasts and services and reduction of harm to subscribers. The licensee is required to continue providing the services under the broadcast license until the date prescribed by the Minister or until completion of such arrangements as the Minister may instruct, whichever is the later. (b) long-term contracts with suppliers.

5.1.7 Alternatives to and changes in products of area of operations

With respect to DBS’s broadcast and service package offered to customers, the following main services may be classified as alternative products:

- 5.1.7.1 The variety of territorial channels and other channels broadcast for free to the Israeli public. These channels include Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the commercial Channel 3 (“Channel 10 Israel”), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel (“Channel 24”), the Russian-language channel (“Israel Plus”), and the Shopping Channel.

For the initiative to set up a land-based and satellite-based digital broadcasting array for distributing various channels, see Section 5.1.3 above.

- 5.1.7.2 Access to video content over broadband, including internet (see section 5.1.4.2 above).
- 5.1.7.3 DVD libraries.

5.1.8 Structure of competition in the areas of operation and changes therein

The concentrated and complex ownership structure in the areas of content, communications and infrastructure in Israel is likely to cause groups throughout the chain of production, packaging and supply of content to move into positions of control. The Cable Company which, together with the corporations related to it, has a broad deployment of advanced broadband infrastructure, markets and sells a package of services including multi-channel television services, high-speed internet infrastructure, and fixed-line telephony. Sale of the service package with these three types of communications services (known as ‘triple play’) whilst DBS does not offer a similar package, constitutes a principal component in differentiating the offer to potential subscribers.

DBS, by cooperating with Bezeq, sells a service package that includes the multi-channel television services provided by it, and Bezeq's high-speed internet infrastructure, thereby providing a partial response to the 'triple' service package sold by the Cable Company. (for this cooperation see section 5.6.5G below).

5.2 Products and Services

DBS's broadcasts provide its subscribers with a wide variety of channels: Around 157 different video channels (of which 30 are pay per view channels) and another 20 radio channels, 30 music channels and 21 information channels (including portals), and interactive services.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport package and the science and nature package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is acting to obtain approval to launch VOD services (See Section 5.6.5F below).

DBS sells its subscribers decoders, which are necessary in order to record its broadcasts. DBS also sells PVR decoders (see section 5.1.4.3 above).

5.3 Revenues and Profitability of Products and Services

Following is a table containing a breakdown of DBS' revenues (in NIS millions):

	2006	2005
Revenues	1,356	1,222
Gross Profit	216	150

5.4 New Products

DBS has the ability to supply VOD services to its subscribers via DSL infrastructure. However, launch of the service requires the receipt of regulatory consents, which have not yet been received, and according to the Ministry of Communications position, legislative amendment, and the consent of the Company (including infrastructure upgrades that Bezeq will be required to effect) – see section 5.6.5(f) below.

5.5 Marketing and Distribution

The marketing of DBS's services is by way of publication in the various media. DBS's sales operations are effected over three main distribution channels:

5.5.1 Sales people in the field working to recruit subscribers.

5.5.2 Telephone service center receiving telephone enquiries from customers wishing to receive DBS services.

5.5.3 External resellers of Bezeq's services working on the basis of agreements with DBS.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 Competitors in the broadcasting market

DBS is in principal direct competition, as set out in section 5.1.1 above, with the Cable Company.

DBS estimates its share of the multi-channel television market as at December 31, 2006, to the best of its knowledge, at around 37% of total subscribers.

5.6.2 Broadcasting characteristics of the competitors

DBS's competitor is the Cable Company. For the operations of the Cable Company see section 5.1.1 above.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the Cable Company transmits its broadcasts to most of their subscribers using a digital broadcasting method and the above-mentioned tiering, while for the remainder it uses an analog broadcasting method, which does not allow viewing electronic broadcasts or tiering and supply of 'personal television' but rather, of one identical channel package (for further implications of this difference, see Section 5.6.4 below).

5.6.3 Characteristics of the current competition

After DBS achieved high rates of growth in subscribers during the first years of its operations, inter alia due to temporary regulatory concessions given to it and a considerable technological gap, together with high churn rates amongst subscribers of the Cable Company, in 2006, there was a relatively slow increment in the number of DBS subscribers (in 2006, the number of subscribers increased by approximately 20,000).

	2006	2005
Increase in number of subscribers	18,887	50,177
Rate of growth	3.6%	10.7%

At present, the competition in the broadcasting sector is focused on content, on the channel packages offered by the broadcasting companies, on prices of channels, on packages and on service (including VOD services which are provided by the Cable Companies). Competition is also characterized by offers of other communications services as part of the service package (see section 5.6.5G below). DBS invests efforts and resources both in marketing its services to the subscribers of its rivals as well as in purchasing special, quality content which it includes in its basket of services and broadcasts.

5.6.4 Positive and negative factors regarding the competition

In the estimation of DBS management, DBS has competitive edges, the principal ones being:

- A DBS makes use of advanced digital technology, which contributes to picture and sound quality; enables a fast and convenient user interface for subscribers when watching broadcasts; enables translation of the broadcast content into foreign languages and the additional of dubbing into other languages (such as into Russian), at the subscriber's election (in most of the DBS's "home channels"); and enables the user to choose a language interface from four options (Hebrew, English, Arabic and Russian). In addition, DBS transmits wide screen broadcasts in a variety of channels which allows subscribers to watch broadcasts in wide screen format (which is similar to the format used in cinemas) on television sets. DBS broadcasts a number of channels using sound technology known as Dolby Digital (which is only supported by some of the decoders).
- B DBS's broadcasts are transmitted via satellite, and therefore the broadcasts can also be received in remote or isolated areas in which there is no access to cable infrastructure.
- C. The quality and variety of content broadcast by DBS to its subscribers.
- D. The level, quality and availability of DBS's customer service system, both telephone service and technical service.

- F. Accessibility and fast installation of equipment for receiving DBS broadcasts for customers living in buildings that are not connected to multi-channel television infrastructure in remote or isolated areas.

However, DBS' competitive operations suffer from inferiority in a number of areas, the main ones being:

- A. Inferiority of regulatory infrastructure in terms of launching of services that require high-speed bi-directional infrastructure, in particular VOD services (See Section 5.6.5F below).
- B. Some of the Cable Company's customers are customers of analog cable systems (see Section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the Cable Company has much greater access to them since the analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.
- C. The directives issued by the administration of the Ministry of Communications, relating to the bi-directional transfer of subscribers between DBS and the Cable Company and use of the infrastructure installed in the homes of subscribers, require 36 hours' notice before disconnection of an existing subscriber of the Cable Company (and vice versa in the case of disconnection of an existing DBS subscriber). The Cable Company can exploit this time frame to make special offers to existing subscribers about to leave it for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the Cable Company, the administrative orders stipulate that payment must be made thereof (and vice versa). However, as at the date of this report, neither the Cable Company nor DBS are in full compliance with the administrative order. For this and the hearing being conducted by the Ministry of Communications with respect to internal wiring, see section 5.14.3 below.
- D. The Company's license imposes restrictions on the structural separation between the Company and its subsidiaries and certain affiliated companies, among them DBS. The longer these restrictions remain in force, and at the same time no similar restrictions are imposed on the Cable Company (and telephony and internet corporations affiliated to them), the more they will harm the DBS's ability to compete (for further details regarding these restrictions, see Section 2.16.2B above).
- E. DBS has inferior infrastructure which does not permit transfer of telephony and internet services over Bezeq's infrastructure or the ability to offer a "bundle of services" on the basis of Bezeq's infrastructure, contrary to the Cable Company whose infrastructure does permit supplying such services. This inferiority is even more pronounced given the regulatory restrictions imposed upon DBS and Bezeq.
- F. Regulatory restrictions of structural separation, including restrictions in the field of joint marketing of products and services, between the Company and its subsidiaries including DBS, restrict DBS's operations. So long as these restrictions remain in force, and at the same time, there are no other similar restrictions on the Cable Company (and a corporation related to it in the field of telephony) harm DBS's ability to offer a bundle of services at a competitive price. In addition, there are regulatory restrictions imposed upon Bezeq with respect to the injection of funds into the Company. Since the Company is a shareholder of DBS, DBS is subject to the restriction on obtaining a license to supply telephony services over broadband internet (VOB), whilst telephony services are offered to subscribers of the Cable Company.
- G. DBS has significant expenses involved in leasing space segments, which are necessary for the purpose of providing DBS's broadcasts.
- H. DBS views the development of IPTV services in Israel as being a factor that might adversely affect its competitive standing in the broadcast field, including entry of additional competitors into the field of multi-channel broadcasts.

5.6.5 Principal methods for coping with competition

The following are the main methods used by DBS to deal with competition in the field of broadcasts:

- A. Branding – cultivation, promotion and differentiation of the "yes" brand;
- B. Content – DBS acts to purchase, produce and broadcast high-quality, innovative and varied content, creating differentiation of its content;

- C. Service – DBS emphasized its customer service and technical service systems;
- D. Technology – continuing investments in technological capabilities and quality of DBS’s broadcasts; emphasizing technological innovation;
- E. PVRs – since DBS views the supply of “personal” television broadcasts as an integral part of the services provided by those operating in the broadcasting market in this modern era, and a significant component of the total bundle of services offered to subscribers, at the beginning of 2005, DBS launched PVR decoders under the brand name yesmax. As at the date of the report, DBS is investing marketing resources to increase the rate of penetration of its PVR decoders among its subscribers. To the best of DBS’s knowledge, the Cable Company also sells PVR decoders to its subscribers.
- F. VOD – whilst the Cable Company commenced providing VOD services to its subscribers at the beginning of 2005, as at the date of this report, DBS has not yet launched such services.

Due to the inferiority of infrastructure as referred to above, DBS applied to make use of the fast bi-directional line owned by Bezeq – DSL (Digital Subscriber Line) and to provide its subscribers with VOD based on that infrastructure, since a technological experiment done on that infrastructure was successful towards the end of 2004. This use of DSL infrastructure requires the consent of the Ministry of Communications, which requested to examine the need to amend the Law regarding the scope of services that a satellite broadcast licensee may supply under the Communications Law and the prohibition imposed upon it in the Communications Law against providing ‘cable services’, as well as the policy regarding the provision of VOD services over Bezeq’s DSL infrastructure. Following applications by DBS to the Ministry of Communications to approve supply of the services to its subscribers on a commercial scale, on October 11, 2005, DBS received the response to the general counsel for the Ministry of Communications stating, *inter alia*, that receipt of a commercial license to provide such services would require statutory amendments and that the Ministry of Communications has not yet formulated its policy regarding the application. Therefore, as the response states, DBS’s application for a commercial license for the provision of the aforesaid services, and a license to perform experimental marketing, is not possible at this stage. Further to this position, the Ministry of Communications invited persons in the communications industry, including DBS, the Cable Company and internet access licensees, to respond to the issue (hereinafter: the “Hearing”). On December 25, 2005, DBS gave its response to the hearing, in which it set out, *inter alia*, the importance and urgency of providing the consent for commercial supply of VOD services to its subscribers.

In January 2007, the Ministry of Communications published a hearing on this matter, with respect to the policy formulated by an internal team at the Ministry of Communications. The policy statement notes, *inter alia*, that the Ministry of Communications examined DBS’s application and decided that there are grounds for permitting DBS to supply VOD services over Bezeq’s ADSL infrastructure, subject to the restrictions set out in the hearing document, including a prohibition against offering VOD services not in the context of DBS’s (and the Cable Company’s) total services, and restrictions to be imposed on Bezeq, as owner of the infrastructure (including a prohibition on Bezeq against providing such services itself, and implementation of egalitarian access to all of the users of its network for the purposes of VOD services). The Ministry of Communications further noted that in light of the aforesaid, it intends to act to amend the Communications Law, so as to enable the council to allow DBS to supply VOD services, even not via satellite. On January 14, 2007, the Ministry of Communications published a memorandum of a government bill to amend the Communications Law so that the Ministry of Communications, following consultation with the Council, should it find that there is a real difficulty in supplying such services via satellite, may permit DBS to supply them other than via satellite. A private member’s bill submitted in October 2006 and authorizing the Minister of Communications to grant the requested license is also pending. On January 30, 2007, DBS submitted its position in this additional hearing to the effect that the Ministry must grant the Company the requested license. On March 15, 2007, the Ministry of Communications published a final position paper on VOD. In this regard, see section 2.6.5 below. On March 18, 2007, a draft of the Law in this matter was approved by the Ministerial Committee on Legislation. The Bill allows content suppliers including DBS to supply VOD services (for DBS, as a licensee for satellite broadcasts as set out above, regarding the memorandum for the Bill).

In February 2007, DBS applied to the State Prosecution Office attaching a draft petition regarding the supply of VOD services. DBS noted that it had exhausted its attempts to receive a license from the Ministry of Communications and at this stage, it had no choice but to petition the High Court of Justice requesting that the court grant it a remedy, and therefore, prior to taking such steps in the High Court, it requested that the State Prosecution Office conduct an investigation as to its claims and requests, set out in the draft petition, in the hope that such investigation would make the need for filing the petition unnecessary. As at the date of the report, the State Prosecution's response has not yet been received. DBS is considering petitioning the High Court of Justice requesting that it instruct the Minister to grant the Company a VOD license forthwith. As stated above, according to the position taken by the Ministry of Communications, set out above, is that even if it is decided as a matter of policy that the application be approved, the launch of VOD services will only be permitted after amendment of the Law in this regard, exception within the context of a minimal technological trial which DBS has recently been conducting under a trial license granted to it in September 2006.

In DBS's opinion, approval of its request to launch VOD services over DSL infrastructure shall constitute a response to the competitive need to launch these services. However, connection of a subscriber to the DSL network is a necessary precondition for provision of the VOD service. In addition, to the best of DBS's knowledge, a considerable share of its subscribers will not be able to receive these services before an upgrade of Bezeq's infrastructure, and the rest of them will only be able to receive the service in a limited fashion until the infrastructure is upgraded. Likewise, launch of the service depends also on Bezeq's consent to supply it under conditions that will enable DBS to be able to provide the service. On the other hand, in DBS's view, the ongoing delay in receiving the consent to provide the VOD service is causing severe harm to its ability to compete with the Cable Company. As at the date of this report, the commercial conditions between DBS and Bezeq regarding launch of VOD services have not yet been concluded.

- G. "Bundle of services" – as set out in section 5.6.5G above, a trend has developed in the field of broadcasts of offering a bundle of communications services as a marketing measure to recruit customers and to retain them, and there is an increasing demand on the part of consumers and potential consumers to receive a total bundle of services enabling them to receive multi-channel television services, high-speed internet connection infrastructure services and fixed line telephony services at lower prices than the prices paid for purchase of each of these services separately.

As a result, DBS currently sells a service package, together with Bezeq, which includes broadcasts and infrastructure to connect to high-speed internet services. However, due to regulatory restrictions imposed upon Bezeq with respect to structural separation between it and its subsidiaries and certain related companies, including DBS, contrary to the Cable Company, which sells its subscribers a triple bundle of services, under which it can also reduce the prices for the bundle of services, DBS is unable to offer a similar bundle.

In July 2006, the Director General of the Ministry of Communications wrote to DBS requesting to terminate its subscriber campaign which it is alleged included a proposed bundle of services, which included, *inter alia*, installation of a Bezeq telephone line at a lower price than that set out in the Communications (Telecommunications & Services) (Payments for Telecommunications Services) Regulations, 5766-2006, in a manner that gave rise to a suspicion of breach of DBS's license, which, so it is alleged, prohibits it from dealing in telephony. DBS was also required to provide information regarding the campaign. DBS replied to the letter, rejecting the Ministry of Communications' claims. DBS also noted that the installation of telephone lines was being done by Bezeq alone, and not by DBS, which is only acting as a dealer for the service, and therefore, its actions do not amount to a breach of the provisions of the law or its license, and they do not require a license. Without derogating from these claims, DBS ceased making this offer to its subscribers.

- H. VOB – in addition, DBS acted to obtain a license for the provision of telephony services via broadband access (voice over broadband) (hereinafter: "VOB") such that it will be able to sell its subscribers, alongside television and internet services, fixed-line telephony services as well. In January 2007, the Minister of Communications published the Ministry of

Communications policy regarding the grant of licenses for the supply of VOB services, in which it was prescribed, *inter alia*, that DBS would not be entitled, at this stage, to receive a license to supply VOB services until Bezeq's market share in the field of domestic fixed-line telephony fell below 85%. However, the Minister decided on an investigation point in a year's time, at which the possibility of granting the Company a VOB license would be examined if DBS's competition status had worsened, and taking into account the competition in the field of domestic fixed-line telephony. However, DBS is not prohibited from marketing the VOB services of another licensee and in a notice published by the Ministry of Communications to the public upon the making of this decision, it was even noticed that in order not to harm the possibility that DBS might market a bundle of services including telephony services using VOB technology, similar to the bundle marketed by the Cable Company, the Ministry is allowing DBS to market such a bundle as aforesaid together with other VOB suppliers. Immediately upon receipt of the decision, DBS wrote to the director general of the Ministry of Communications, asking to receive all of the data and documents that were before the Minister when he made his decision, emphasizing that this was a decision with difficult implications and that on the face of it, it was not clear what had brought it about. Following this letter, the DBS received a number of documents, but not all of the documents that it had requested, and it was also not given any confirmation that the documents transferred were all of the relevant documents. In light of that, DBS once again contacted the Ministry of Communications on February 27, 2007 and on March 6, 2007, and gave notice that in light of the severity of the harm, it was considering petitioning against the policy decision to the High Court of Justice, and that if it did not receive additional documents as it requested in its letters within 10 days of the date of such letter, it would be forced to rely in its petition on the partial material that it was given. As at the date of this report, no response to the above letter has been received and DBS is considering petitioning against the policy decision to the High Court of Justice.

5.7 Property Plant & Equipment

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re'em Junction, leased space segments on the Amos 1 and Amos 2 satellites and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

5.7.1 Rental of structures

DBS's main offices, including its management, broadcast center and other operations departments, are in three buildings in the Eastern Industrial Zone at Kfar Saba, in an area covering approximately 9,701 sqm, alongside which there is a parking lot and adjacent facilities: An area of approximately 7,077 sqm (in which the broadcast center is situated) are leased by a third party, in accordance with a memorandum of understanding dated May 1999. The lease ends in November 2009, and the Company has an option to extend the term of the lease by 10 more years under the same conditions. The Company has a right of first refusal to purchase the premises from Azorim, should such be put up for sale; an area of approximately 1,994 sqm in another adjacent building is leased by a third party, the term of which lease ends in July 2008.

In addition, DBS runs two operational centers, one being in the Neshet Industrial Zone (some 1,322 sqm in area, which is leased by a third party until May 2008) and the second in the Industrial Zone at Kanot (some 1,487 sqm in area, which is leased to a third party until July 2011), and these are used as technical service and sale centers for subscribers in the north and south of the country; in addition, nation-wide telephone service centers operate from them.

5.7.2 Terminal Equipment

DBS installs a receiver dish and other terminal equipment in subscriber homes, including decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see Section 5.15.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are

made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them.

5.8 Intangible assets

5.8.1 Licenses

DBS owns the following licenses:

- 5.8.1.1 Broadcasting license valid until January 2014 – this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see Section 5.14 below).
- 5.8.1.2 License for satellite television broadcasts in the Judea and Samaria region valid until January 2009, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judea and Samaria region.
- 5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until January 2014 or until the end of DBS's broadcast license, whichever is the earlier. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.
- 5.8.1.4 License for the provision of uplink/downlink services to other communication licensees which is valid until July 2008. As at the date of publication of this report, DBS does not use this license.

5.8.2 Intellectual property assets

A. Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered on the Register of Trademarks. The main trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

B. Copyright organizations

DBS owns the copyright to the various television content it produces as well as the copyright usage licenses owned by third parties for the purpose of broadcasting and integration into the framework of its subscriber broadcasts. The broadcast of content in which DBS owns broadcast rights involves the payment of royalties to the owners of intellectual property – i.e., copyright and performers rights in sound recordings for actual broadcasting, including under the Copyright Law and the Performers and Broadcasters Rights Law, 5744-1984. Payment of royalties as aforesaid is done via a number of organizations that operate in Israel, which collect the royalties owing to the owners of the intellectual property rights and in return provide the broadcasting entities with blanket licenses. For some of these licenses which represent principal royalty payments, the final sum owing from DBS for uses under the license is prescribed in accordance with the final sum paid by the Cable Company to the licensee for every subscriber, either in the case of an agreement between them and the licensee or in the event of a judicial ruling on a dispute between the parties, the consideration owing from DBS being no less, in any event, than that paid currently under the license. Payments by DBS under these licenses are based mainly on a fixed payment and sometimes on various pricing methods, including those that depend on the number of subscribers as aforesaid.

For some of the content that DBS purchases, it is also required to pay for the actual broadcast of the content.

DBS's costs to such collection organizations in 2006 amounted to approximately NIS 13 million.

C. Investment in content

DBS purchased broadcasting rights for 2006 from various owners of copyrights to intellectual property for purchased content. DBS's rights to use such content are extremely important for its operations, since its main broadcasts are via use of the content of third parties, and via integration of acquired content and content used by DBS in order to produce programs and previews. DBS from time to time grants rights of use in television content produced or purchased by it to franchisees of the Second Television and Radio Authority, for the purpose of re-broadcasting such content.

D. Costs of acquisition of subscribers.

See Note 3 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

E. Software

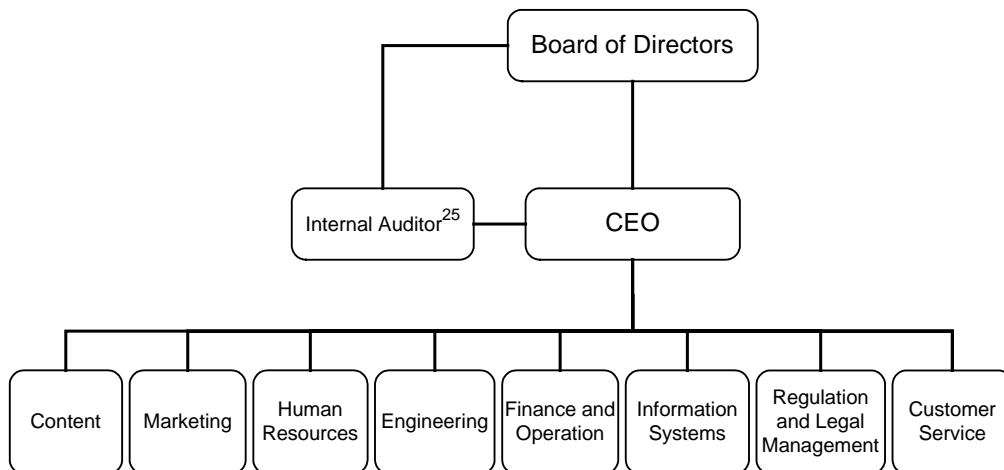
See Note 3 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

5.9 Human Resources

5.9.1 Organizational structure

DBS has 8 departments, each one headed by a VP who is a member of management of DBS. DBS's departments are:

marketing, customers (including recruitment of customers and service), content, engineering, finance and operations, human resources, regulation and legal administration, and information systems:



²⁴ The auditor is an external auditor.

5.9.2 **DBS personnel by division**

Division	Number of Employees		
	As at December 31, 2004	As at December 31, 2005	As at December 31, 2006
Marketing Department ²⁵	24	17	21
Sales Department	366	346	289
Customers Division ²⁶	1,142	1,050	1,016
Content Department	39	48	52
Engineering Department	61	69	72
Finance and Operations Department	90	103	95
Human Resources Department ²⁷	9	8	9
Regulation and Legal Administration Department	1	1	1
Information Systems Department	5	24	54
Total	1,737	1,674	1,609

5.9.3 **Training and development of human capital**

DBS provides regular training for its customer service, technical service and sales personnel.

In 2005, DBS consolidated its training and instruction center consolidating the three main training tracks, which is used as a training center for all DBS managers and employees.

DBS trains some 1,000 employees every year.

5.9.4 **Organizational change**

In 2005, the Marketing and Sales Departments were merged into one Department. The Customer Service and Technical Sales Departments were also merged into the Customers Division. In 2006, the Sales Department was merged into the Customers Division, and the Marketing Department became an independent department.

5.9.5 **Employee remuneration schemes**

DBS has a remunerations plan based on targets for senior management of DBS. For the options to DBS office bearers see Note 26 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report.

5.10 **Raw materials and suppliers**

5.10.1 **Main raw materials**

The main raw materials used by DBS for its broadcasting operations are:

A. **Television content**

Television content, broadcasting and broadcasting channel rights purchased by DBS for its broadcasts. The broadcasting rights include movies, series and other original programs from local and foreign producers, mainly from the USA (see section 5.8.2 above).

²⁵ In 2004, there were separate Marketing and Sales Departments, which were unified in April 2005 into a Marketing and Sales Department. At the end of 2006, the Company's Sales Department was integrated into the Customers Division, and Marketing went back to being an independent department (which accounts for the increase in employees in the Customers Division as at December 31, 2006, and the corresponding decrease in the number of employees of the Marketing Department as at the same date).

²⁶ In 2004, the Customers Division was divided into the Technical Logistic Service Department and the Customer Service Department, and these departments united into the Customers Division in April 2005. At the end of 2006, the Sales Department was also brought into the Customers Division.

²⁷ In January 2007, the training sections of the Company's various departments was unified into central administration as part of the Human Resources Department.

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of original productions made for DBS which, under purchase agreements, may be broadcast a number of times or which may be sold to third parties are deemed to be part of DBS's broadcast rights inventory, and the cost of them is amortized over the period of their expected use, or in accordance with the estimated number of future screenings of such programs, but in any event, are amortized in full upon expiration of the broadcast rights under the contract.

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for the channels known as "Channel 5" and "Channel 5+" from the provider of these contents (JCS). There is also dependence on the other supplier of sport content, Charlton Ltd.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with two owners of the rights to the space segments (see Section 5.15.2 below).

DBS is dependent on the continuing regular availability of the space segments (see Section 5.19(E) below).

As at the date of this report, DBS pays the current rental on space segments on the Amos 1 satellite, and makes partial payments on account of the rental debt for previous periods the time for payment thereof to the Israel Aviation Industry has passed (due to assignment of the right to receive rental from HLL to the IAI). In light of DBS's arrearage in payments prescribed under the above agreement, IAI wrote to DBS in March 2006, requesting the payment of any debt, and the parties are negotiating on this. In addition, DBS and HLL are in dispute as to the amount of annual rental owing to HLL for lease of space segments on the Amos 2 satellite, which has not yet been regulated, DBS paying the sums that are not in dispute only, and paid HLL an additional one-time sum which constitutes part of the sums that are in dispute. In March 2007, HLL gave notice to the Company that if the sums that it claims are owing to it are not paid, it shall submit a claim to the arbitrator in accordance with the agreement between the Parties. In this regard, see Note 18 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report.

C. Digital decoders

DBS purchases digital decoders for the purpose of receiving and decoding its broadcasts, which are encrypted, at the customers' home. DBS is dependent upon the supplier from which the decoders are purchased. Replacement of this supplier with another supplier would not entail material extra cost, but the replacement would require a significant preparation period to adapt the decoders of the replacement supplier to DBS' broadcasting and encryption system. For a description of the agreement with this supplier see Section 5.15.1 below.

D. Operating and encryption systems

DBS purchases from NDS services linked to the operating systems of its broadcasting setup and encryption means (see Section 5.15.3 below) as well as hardware for these services. DBS is dependent upon the regular provision of these services.

5.11 Working capital

5.11.1 Accounts Receivable

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2006, customer credit amounted to approximately NIS 149,181,000 net.

5.11.2 Supplier credit

The average supplier credit period in 2006 was 146 days.

5.11.3 Deficit in working capital

As at December 31, 2006, DBS's deficit in working capital amounted to NIS 1,550,754,000. In 2005 and 2006, DBS reduced its working capital deficit.

5.12 Financing

5.12.1 Average interest rate for loans

5.12.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

5.12.1.2 CPI-linked non -interest bearing loans.

5.12.1.3 CPI-linked loans bearing annual interest of 5.5%.

5.12.1.4 CPI-linked loans bearing annual interest of 11%.

5.12.1.5 Institutional bodies

Loans provided to DBS by institutional bodies in 2005 are linked to the consumer price index and bear interest at an annual rate of 11%. Loans provided to DBS by institutional bodies in 2006 are linked to the consumer price index and bear interest at an annual rate of 8%.

5.12.1.6 Banks

Short-term credit – the average interest rate for this credit for 2006 is 7.83%.

Long-term credit – there are two types of loans:

Loans based on prime interest rates where the average interest rate for 2006 is 7.88%.

CPI-linked loans where the average interest rate is 6.64%.

5.12.2 Credit restrictions applicable to corporations

Pursuant to the finance agreement of May 2001, as amended from time to time, between DBS and a bank consortium which arranged bank finance for DBS (hereinafter: the "Finance Agreement"), DBS must comply with all the following financial criteria:

- A. Minimum overall income.
- B. Minimum operating surplus.
- C. Minimum operating surplus less DBS investment in decoders and modems.
- D. Maximum and minimum supplier credit.
- E. Minimum targets for coverage of the bank debt and debt balances.
- F. Maximum overall finance requirements.
- G. Maximum churn rate.

The values for meeting the financial criteria are variable and are measured quarterly. Non-compliance grants the banks the right to demand early repayment of the loans and the right not to award DBS any further unused credit line. During 2005, the banks completed providing the entire credit limit to which the Company was entitled under the financing agreement (apart from the sum of approximately half a million shekels) in return for the

provision of shareholders' loans by the shareholders of DBS in the rates required under the financing agreement (apart from shareholders loans which the banks waived under the amendment to the financing agreement dated December 2005, as replaced in the schedule to the financing agreement dated May 2006 (in this section: the "**amending document**"). Under the amending document, the banks confirmed that actual investments by shareholders in DBS by the end of 2005, despite certain deficits therein compared with the values prescribed in advance in the financing agreement, do not constitute a breach of the financing agreement. Under the amending document, the bank credit limit was increased (in this section: the "**additional credit**"). Under the amending document, the additional credit is intended to be repaid by the end of 2008, in the installments set out in the amending document, however, in the event of injection of shareholders' equity into DBS by its shareholders, or external credit (in such sum and on such conditions as require receipt of the banks' consent under the financing agreement) before the date of repayment of the additional credit, DBS is required to repay the additional credit early, in the amount of the sum injected. It was further agreed that the interest rates on the bank credit would be increased until full repayment of the additional credit.

During 2006, DBS began gradual repayment of the bank credit taken by it, up until full repayment in 2013. As at December 31, 2006, DBS is in compliance with these conditions (following relief granted to it in December 2006). However, DBS's management does not expect that it will be in compliance with the aforesaid conditions in 2007. Given this forecast, loans from the banking corporations are presented under short-term liabilities.

In light of the forecasts of DBS's management regarding the business results for 2007, DBS applied to the banks in order to plan and adjust targets prior to full repayment of the bank credit. As at the date of approval of the financial statements, the aforesaid conditions have not yet been concluded. DBS is also negotiating with the banking corporations to resolve a dispute regarding insurance undertakings set out in the financing agreement.

In addition to the above-mentioned financial commitments, pursuant to the Finance Agreement additional restrictions anchored therein apply to DBS, the main ones being:

- A. Restrictions on its compliance with its business plan and the update of this plan.
- B. Restrictions on the assumption of third-party liabilities, including the receiving and granting of credit.
- C. Restrictions on the distribution of profits and payment of management fees to the shareholders.
- D. Restrictions on the creation of pledges and sale of certain assets without consent from the banks.
- E. Restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures).
- F. Restrictions relating to the shareholders loans provided to DBS by the Company, including their inferiority to bank credit (and to debentures issued to the public, if any), and restrictions regarding the repayment of them prior to full repayment of the bank credit, or taking into account certain shareholders loans before some of the bank credit is repaid, as set out in the financing agreement.

DBS is bound by mandatory repayment of sums that it receives with respect to the placements of shares or debentures to the public, sale or transfer of property and certain cash surpluses of DBS, on the conditions and at the rates set out in the financing agreement. DBS may, voluntarily, effect early repayment sums received with respect to placements of shares or debentures to the public, which may remain after the aforesaid mandatory repayment, on such conditions and at such rates as are set out in the financing agreement.

The financing agreement also sets out provisions regarding various reports which DBS is required to provide to the banks, including with respect to examination of its compliance with financial conditions.

The financing agreement sets out a list of events which amount to breach thereof, and which entitle the banks, under the conditions set out in the financing agreement, to make the bank credit immediately repayable.

DBS encumbered its assets and goodwill with a floating charge in favor of the banks and placed fixed charges over its rights in accordance with material agreements to which it is a party and the insurance rights to which it is entitled under the insurance policies taken out for it.

DBS shareholders, with the exception of the Company, charged the DBS securities in their possession in favor of the banks, to secure the amounts which the banks made available and will make available to DBS. Most of the shareholders also charged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that these loans would be inferior to the bank credit. In view of the restrictions on the Company's ability to charge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Note 13 to the Company's financial statements for the year ended December 31, 2006, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders charged in their favor. The Company also gave an undertaking to sell its shares if the shares charged by the banks are sold. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

As at the date of this report, DBS is not in compliance with all of its undertakings under the financing agreement to take out insurance with respect to its operations and assets, including with respect to the duty to take out satellite failure insurance for the satellites on which DBS leases space segments for the purpose of its broadcasts. DBS is negotiating with the banks for relief with respect to its insurance undertakings, which will enable it to comply with these undertakings.

In addition, arrears in DBS's payments to the Israel Aviation Industry (as set out in section 5.10.1 above), constitutes a prima facie breach of the financing agreement, however, the banks have allowed DBS not to deem the demand by IAI for repayment of the debt, and non-payment of the debt, as a breach by DBS of the financing agreement, provided that by March 31, 2007, the parties reach a written arrangement with the IAI regarding repayment of such debt, and that during the period prior to March 31, 2007, IAI does not institute any measures for collecting its debt as aforesaid.

As at the date of approval of the financial statements, DBS is acting to obtain additional sources of finance in order to enable it to realize its goals for the coming year. If these sources are not obtained, DBS shall act in accordance with its alternative business plan, which does not require additional sources of finance to those already existing.

5.12.3 Credit amounts received in 2006

In 2006, DBS received a loan from a number of related institutional parties in the sum of NIS 50 million (principal). In December 2006, DBS received a loan in the total sum of NIS 50 million (principal) from a number of related institutional parties. The loan is linked to the CPI and bears interest at an annual rate of 8%, the principal of the loan being expected to be repaid in three annual installments, commencing on December 31, 2013, and the interest on the loan to be paid in regular quarterly installments, however, the lender has the right to receive repayment of the loan prior to the making of any payments to DBS's shareholders, including dividends, management fees and repayment of shareholders loans, but not including payments to suppliers. DBS has an option for a fixed period to take out another loan in the amount of NIS 50 million at agreed interest, provided that it complies with a financial goal prescribed in the loan agreement. This credit is inferior in terms of repayment to the bank credit, however, DBS, the banks and the lenders agreed that the loan could be repaid in accordance with the repayment table (even prior to repayment of the full bank credit) so long as the banks have not given a declaration regarding the occurrence of an event of breach with respect to the financing agreement

and/or notice of the making of the bank credit immediately repayable. It was also agreed that this loan could be repaid on account of DBS's right to repay the shareholders' loan provided and to be provided by the shareholders in DBS, after April 1, 2004.

DBS and/or its shareholders have not given any guarantee and/or surety in assurance of repayment of this loan.

5.12.4 The Corporation's credit facility

DBS's credit facility is approximately NIS 1,430 million and it is used for the current operation and the granting of bank guarantees for DBS's operations. As at December 31, 2006 DBS has utilized NIS 1,400 million of this credit.

The credit taken by DBS from institutional entities (at a total rate of NIS 100 million) in 2005 was received under loan agreements dated March 2005 and April 2005. This credit was taken on inferior repayment conditions compared with the bank credit, apart from exceptions that are similar to those which apply to the shareholders' loans provided by shareholders of DBS after April 1, 2004. In assurance of repayment of the loans to institutional entities, an undertaking was given by the Company (which is conditional, *inter alia*, upon DBS having a positive worth), as set out in Note 19 to the financial statements of the Company for the year ending December 31, 2006, which are included in this periodic report, and the banks that are financing DBS's operations agreed that in the event of exercise of the Company's shares in DBS by them, the financial entities shall be entitled to a proportionate part of the receipts of such, at the rate set out in the agreements. The institutional entities were also given an option to provide loans in an identical sum to that provided by them provided that the sums of the loans are required under DBS's business plan, and this option is exercised by them in full. Contemporaneous with these agreements, appropriate amendments were signed to the financing agreement with the banks that finance DBS's operations, the principal point of which is viewing the loans received from the institutional entities as being shareholders loans, as aforesaid.

5.12.5 Need for raising of additional sources of capital

DBS's management is acting to obtain additional sources of finance in order to enable it to realize its plans for the coming year. If such sources are not obtained, DBS shall operate in accordance with an alternative business plan, based on the sources of finance available to it at present.

For details regarding the shareholders' loans from its shareholders and for the position taken by the Ministry of Communications regarding the provision of shareholders loans by the Company, see section 5.19.3 below and Note 32 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report.

5.13 Taxation

See Note 8 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

Assessments were issued to the Company for 2000-2004, under which the losses for tax purposes carried forward to subsequent years were reduced by 21 million, pre-business expenses from 2000 will amount to NIS 83 million and will be recognized over 10 years, and expenses in the sum of NIS 162 million recognized in previous years will be deferred to subsequent years.

5.14 Restrictions on and Supervision of the Corporation

5.14.1 Subjection of activities to specific laws

DBS's operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The above legislation, secondary legislation, resolutions of the Council and administrative directives have a substantial impact on DBS and its operations. Likewise, legislation and secondary legislation in the field of communications in general has a substantial impact on DBS.

Restrictions are applicable to DBS by virtue of the Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations, 5758-1998

(hereinafter: the “License Regulations”), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee during the term of the license. The License Regulations prescribe, *inter alia*, suitability conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

The Telecommunications (Television Broadcasts via Satellite) (License Fee and Royalties) Regulations, 5759-1999 (hereinafter: the “**Royalty Regulations**”) as amended in August 2006, provide the rate of royalties and the broadcast license fees to be paid by a licensee for satellite broadcasts to the State. Under those regulations, DBS owes royalties in a rate of 3.5% of its revenues from the provision of broadcasting services in the years 2004 and 2005, in the rate of 3% for 2006 and in a rate of 2.5% for 2007. The royalty rate will be 2% in 2008, 1.5% in 2009 and 1% from 2010 onwards.

Under Section 6WW of the Communications Law, the license may prescribe the maximum prices that a subscriber may be billed. As at the date of this report, no such prices have been prescribed.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, in 2004 and 2005 DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees. According to a decision of the Council dated September 2005, the rate of investment of DBS’s revenues in local productions during the years 2006 and 2007 will stand at 8% of such revenues.

Under the requirements of the law and the license, DBS is required to allow independent channel producers under section 6EEE of the Communications Law to make use of its infrastructure in order to distribute transmissions to its subscribers, in return for payment to be set out in an agreement, and in the absence of any agreement, in consideration for payment to be prescribed by the Minister, upon consultation with the Council.

DBS complied with its duty regarding original productions for 2004 (including the proportionate part of supplementation of past debts), apart from non-substantial deviations in the sub-division for various classes, which the Council instructed DBS to remedy during 2005. In September 2006, the Council confirmed that DBS was in compliance with its original products duty for 2005 (including the proportionate part of supplementation of past debts) apart from non-substantial deviations for the sub-division for various classes.

5.14.2 Operations subject to broadcasting license

DBS’s operations are subject to the provisions of its broadcasting license. The Communications Law, the License Regulations and the license stipulate a number of grounds on the basis of which the Minister of Communications can terminate, restrict or make the broadcasting license conditional, after consultation with the Council and the granting of a hearing to the broadcasting licensee, among them, violation of the provisions of the law or rules and regulations pursuant thereto, a material violation of the terms of the broadcasting license or a non-material violation which was not amended after a warning from the Minister or the Council, the cessation of broadcasts for an unreasonable period of time or the total cessation of broadcasts for 14 consecutive days, noncompliance of the licensee with the restrictions determined in relation thereto in the License Regulations, and the appointment of a receiver or temporary liquidator for the licensee or the issuing of a liquidation order, all pertaining to the licensee.

The Minister of Communications, in consultation with the Council, and after granting the broadcasting licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, *inter alia*, for the purpose of the goals stipulated in the license. In addition, the Council alone has concurrent authority to amend the broadcasting license, provided that the broadcast licensee is first of all given an opportunity to make claims.

5.14.3 Principal restrictions by virtue of the law and broadcasting license

The Communications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards,

which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation; an encumbrance placed on any of the broadcasting license's assets shall not be realized unless as determined by the Minister of Communications; DBS's broadcasts under the broadcasting license, and the scope thereof, are subject to the Law (for the statutory restriction on VOD services, see Section 5.6.5F above); a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more or in any percentage resulting in a person becoming an interested party or controlling party in the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to said shares listed on the Stock Exchange); reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties thereto, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the Cable Companies) except for the transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts.

The broadcasting license also contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications; conditions regarding whether the terminal equipment installed by DBS complies with standards.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The broadcasting license also stipulates that the list of prices that the broadcasting licensee collects from its subscribers for broadcasts and services shall be first submitted to the Council for approval, and that any amendment thereto shall be first submitted to the chair of the Council for approval. The Council does not intervene in DBS' tariffs but ensures that there is no bias or discrimination between subscribers or breach of the provisions of the law. With respect to reductions, discounts and promotions (for a restricted period), DBS is required to notify the chair of the Council no later than the date of publication or commencement, whichever is the earlier, and the chair may intervene if he finds them to be misleading to the public or as drawing distinctions between subscribers.

The broadcasting license sets out a number of provisions that relate to the content of DBS's broadcasts, including approval of the channels broadcast by DBS and amendments in respect of them by the Council (including the content of DBS's basic package), approval of the electronic program guide (EPG) which is part of DBS's digital service to its subscribers and approval of pay per view broadcasts.

DBS is also required to transmit the television and radio (FM) channels lawfully broadcast in Israel which can be received from the air, ground or satellite, the educational television channel and "must carry" broadcasts to its subscribers. Under the provisions of the Law, DBS currently transmits broadcasts of two "must carry" channels, the music channel ("Channel 24") and the Russian-language channel ("Israel Plus"), in return for a sum to be set by the Minister of Communications (as at the date of publication of this report a fixed payment had not yet been set for the transmission of the "must carry" channel), and also two independent licensees "Nature of Things Channel" and "Clicka" channel which collect subscriber fees directly from their customers.

Pursuant to a decision of the Council dated March 2006, DBS, including its shareholders, are entitled to own up to 30% of the local channels broadcast in DBS's broadcasts (compared with a 20% restriction that applies to the Cable Company).

In 2001, the Ministry of Communications issued administrative orders regulating the method of transferring subscribers from the services of the Cable Company to DBS and vice versa, and use of the infrastructure installed in the subscriber's home (the "administrative orders"). The administrative orders also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider.

Since entry into force of the administrative orders, the Cable Company has made claims against DBS to the effect that it is in breach of the administrative orders. DBS for its part has made claims to both the Ministry of Communications and to the Cable Company regarding breach of the administrative orders by the Cable Company.

On August 16, 2004, DBS received a letter from the Director General of the Ministry of Communications in which he gave notice to DBS that given the extent of its breaches of the administrative order, he intended to issue a demand on DBS to pay financial sanctions for 15 breaches out of all of the breaches that it committed, in a total sum of NIS 1,354,500. DBS objected to the imposition of this financial sanction and to date, no such letter of demand has been received.

On August 15, 2005, the Ministry of Communications gave notice to DBS and the Cable Company that in light of their many breaches of the administrative orders, it has examined the issue and is currently considering repealing them *inter alia* in light of the mechanism for purchasing wiring set out in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120. On November 2, 2005, DBS submitted its position to the Ministry of Communications to the effect that the administrative orders should remain in force, whilst repealing the prior notice obligations set out therein which require the giving of notice to the party whose subscribers are disconnecting from their service. DBS also claimed that the statutory provision affording title to the multi-channel television provider over the infrastructure installed by it in the subscriber's home should also be repealed. DBS claimed that at least, if this provision is to remain, then the proper interpretation of it ought not be to give the Cable Company title to the wiring installed by them in private homes. DBS also claimed that the sum set out in the Law as the consideration to be paid for purchase of the wiring (NIS 120) has no basis and that should the provision remain in force, it should be reduced considerably. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and has many faults, and will prevent the proper transfer of subscribers under it, and will harm competition. As at the date of this report, the results of the hearing have not yet been reported.

At the beginning of March 2006, the Cable Company gave notice to the director general of the Ministry of Communications that in light of DBS's breaches of the administrative order, it was ceasing to accept disconnection notices sent to it by DBS, and indeed, the Cable Company ceased accepting any notices under the administrative order, including connection plans and termination notices. DBS dismissed the claims made by the Cable Company and argued that by refusing to receive notices from DBS, not only was the Cable Company in breach of the administrative order, it was also in breach of its license and of the agreements via which it had contracted with its customers, since it continued charging subscribers a subscription fee despite knowing that such subscribers had disconnected from their broadcasts. DBS also demanded that the Ministry of Communications order the Cable Company to stop charging subscribers immediately upon receipt of notice of disconnection. Following these letters, further correspondence was conducted between the Cable Company and DBS, in which each party repeated its claims. As at the present date, the Ministry of Communications has not yet commented on the issue, and the Cable Company continues not to accept notices from DBS.

In the assessment of management of DBS, if the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the transition of subscribers between the various suppliers.

As at the date of this report, the Council has granted another license to broadcast a special Jewish heritage channel which is also expected to be transmitted via DBS's broadcasts. At present, the broadcasts of independent licensees are not transmitted via DBS.

5.15 Substantial agreements

Following is a summary description of the principal agreements likely to be considered as material agreements not in the normal course of business of DBS which have been signed and/or are valid in the period of the Periodic Report:

5.15.1 Agreement for the purchase of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: "ADB") and Eurocom Marketing (1986) Ltd. (hereinafter: "Eurocom"), in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the "**ADB Agreement**"). Under the ADB Agreement, DBS purchased a minimum number of decoders from ADB and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS is to send to Eurocom. DBS also has a warranty for the decoders and support service for them from Eurocom. Repair to the decoders is carried out in accordance with an agreement with it from April 2001, which is automatically renewed unless terminated by one of the parties thereto, and which determines conditions and dates for the provision of maintenance services (and replacement of the decoders, if necessary) by Eurocom. In 2006, DBS purchased decoders from Eurocom in the total sum of approximately NIS 55 million. As at the date of these statements, DBS has ordered more decoders under the ADB agreement. Following allegations by DBS with respect to hardware malfunctions in a considerable proportion of the decoders supplied to it by ADB, DBS is negotiating with ADB in formulating an arrangement which shall extend the supplier's liability term for the decoders for another three years for each malfunction.

In December 2006, a deficit demand was sent to Eurocom by the Customs Department at the Taxation Authority for decoders purchased by DBS from Eurocom Marketing and smart cards that had been imported by Eurocom for DBS in the total sum of NIS 10 million (including the sum of approximately NIS 5 million in VAT which, in the assessment of Eurocom Marketing's legal advisers, there is a reasonable chance that there is no effective debt owed for such). Eurocom is currently objecting to the deficit demand, and DBS has provided the securities required by the Customs Department to insure the taxes in dispute. As at the date of this report, a decision has not yet been made with respect to the objection to the deficit demand.

5.15.2 Space segment lease agreements

First space agreement

In order to transmit the satellite broadcasts DBS signed an agreement in April 1999 with the HLL Satellite Communications Company (Spacecom) Ltd. (hereinafter: "HLL"), in which there is an interested party which is also an interested party in DBS, and with Israel Aircraft Industries for the leasing of space segments in the Amos 1 satellite as amended in May 2003 (hereinafter: the "First Space Agreement"). The lease period determined in the First Space Agreement will conclude on June 30, 2009 (in relation to the period from January 1, 2009 – subject to the purchase by DBS of insurance cover as defined in the agreement) or upon the end of the life of the Amos I satellite, the earlier of the two, and if DBS continues to use the space segments after the end of the lease period, it shall continue to pay the leasing fees. DBS has undertaken to lease at least 8 space segments on the satellite. According to information provided to DBS by Israel Aviation Industries (IAI), the Amos 1 satellite is not expected to stop operations before June 2008, the estimated time of termination of operations is during October 2008. These assessments by IAI are forward-looking information based, to the best of DBS's knowledge, on calculations that IAI has done, in accordance with various technical parameters. However, technical failures and other events might also affect the life-span of the satellite.

DBS also has an option to lease up to 2.5 additional space segments (and in a particular case, an additional half a segment) and a right of first refusal to lease all of the space segments in the satellite's Mediterranean beam, which shall be offered for lease by HLL or IAI. As at the date of publication of this periodic report, DBS has not completed the reduction of its past debt as required under the amendment to the agreement of May 2003.

The rental set out in the First Space Agreement is made up of annual rental for each space segment which DBS uses.

The First Space Agreement regulated mechanisms guaranteeing reserve and backup in the event of satellite faults. *Inter alia*, it was prescribed that the satellite's reserve

transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault contemporaneous with another capacity DBS has priority for the restoration of the capacity that it has leased.

Second Space Agreement

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (hereinafter: the "**Second Space Agreement**"), whereby DBS leases from HLL no fewer than 12 space segments on the two satellites (of which 8 on Amos 1), and during 2005 DBS started to lease two additional segments on the same polarity, so there will be no need to adjust DBS's receiver dishes. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, the earlier of the two. The consideration for the lease determined in the Second Space Agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments leased on the Amos 2 satellite, DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the Second Space Agreement. The Second Space Agreement brings together space segments which are to be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

HLL has undertaken to act to extend the lease period for the space segments beyond the current lease period, and for this purpose to endeavor to station a subsequent satellite in a suitable position, with similar technical characteristics, so that it will not be necessary to make changes to the receiver systems of DBS subscribers, under the conditions determined in the agreement, until December 31, 2013, provided that an appropriate agreement for the continuation of the satellite's life is signed by the parties, as shall be determined in said agreement, pursuant to which DBS will lease at least 14 space segments in consideration of annual leasing fees under similar commercial conditions.

As at the date of this report, DBS leases 7 space segments on the Amos 1 satellite (out of the 8 segments under the First Space Agreement), due to a technical restriction which prevented leasing of the eighth segment for a very long period, which required DBS to implement alternative permanent solutions. DBS held negotiations with Aviation Industries regarding the obligation to lease the eighth segment, and the cost thereof. In fact, as at the date of the report, IAI is not charging DBS for lease of the eighth segment. As at the date of this report, DBS is also leasing 6 space segments on the Amos 2 satellite. The rental in 2006 for the First Space Agreement and the Second Space Agreement amounted to approximately NIS 116 million. For the monetary dispute with HLL see section 5.10.1(b) above.

5.15.3 Information and encryption system development agreement

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "NDS") for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. The provisions of the agreement were applied in January 2006, *mutatis mutandis*, to the advanced (second generation) version of the smart card. DBS pays for NDS's services and products based in principle on the number of converters it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber

services, the granting of usage licenses for these applications and the development of future interactive technological services.

5.15.4 Information systems outsourcing agreement

In March 2004, DBS signed an outsourcing agreement with Ness A. T. Ltd. (hereinafter: "Ness") whereby DBS transferred its information system management and project implementation services (hereinafter: the "Service") to Ness and Ness assumed overall responsibility for the supply to DBS of the Service in an outsourcing format. DBS also transferred to the ownership of Ness certain equipment for which the services are provided and which will be transferred to DBS upon expiry of the agreement. The agreement period (subject to early termination rights conditional upon payment) has been defined as eight years from April 1, 2004 (hereinafter: the "Original Agreement Period"), and at the end of the Original Agreement Period the agreement term will be extended automatically for an additional period of five years (hereinafter: the "Extension Period"), unless one party notifies the other party in writing, at least 12 months before the end of the Original Agreement Period of its desire not to extend the Original Agreement Period. During the Extension Period each party may notify the other party in writing, at least 12 months in advance, of its desire to terminate the agreement. During 2005, the Parties agreed to stop the outsourcing of certain of DBS's information systems and to return them into DBS's management. In January 2007, a further amendment to the agreement was signed between the parties (hereinafter: the "additional agreement"), which is to apply retroactively as of January 2006, under which it was agreed, *inter alia*, that the scope of HR services be reduced, and that payments continue to be made for projects until the end of the original agreement term. Likewise, the contract mechanism was altered so that equipment purchasing and maintenance agreements with suppliers were taken out of the ambit of the agreement, and these will be purchased by DBS. Under the additional amendment, each party may terminate the agreement by prior written notice of 30 days.

Termination of the agreement prior to the end of the original term of the agreement shall involve the payment of a separation fee in accordance with the provisions of the agreement.

5.15.5 Finance agreement with the banks

For a summary of the main points of the agreement, see Section 5.12 above and Note 32 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

5.15.6 Agreements with DBS shareholders – see Section 2.17.3 above.

5.15.7 Agreements with institutional entities – see Section 5.12.4 above.

5.16 Joint venture agreements

5.16.1 DBS purchases annual internet access packages at high baud rates based on DSL infrastructure, and sells these packages to its subscribers non-exclusively together with its broadcasts and services to its subscribers (see Section 5.6.5 above).

5.16.2 DBS has a joint venture with Bezeq International Ltd., a subsidiary of the Company, for the supply of a basket of services including multi-channel television services (supplied by DBS), infrastructure connection to the internet and internet access services (supplied by Bezeq International Ltd.). The joint venture operates under the brand name "yes-Wow". Since 2005, the joint venture has been operating to retain customers only, and no marketing or sales efforts have been made.

Under the venture, each party bears its own expenses (i.e. Bezeq International Ltd. re all matters relating to internet access services and DBS regarding all matters relating to multi-channel television services).

5.16.3 DBS and Microsoft Israel Ltd. (hereinafter: "Microsoft") are setting up a marketing and technical joint venture with respect to a media center system which is a system that includes software components and mostly also content which enables the viewing, on television screens, of video content transmitted to the viewer via the internet, and content saved at the viewer's home. As part of this joint venture, the media center will interface with DBS's website and it shall be possible to view DBS's content as transmitted using Broadband TV technology.

5.17 Legal Proceedings

- 5.17.1** On July 6, 2005, DBS submitted a statement of claim in the District Court at Tel Aviv against Pace Micro Technology Plc., in which DBS requested that the court require the defendant to pay the direct costs that DBS incurred in order to fix defective decoders of a particular model assembled and/or manufactured by the defendant and supplied to DBS in 2000-2001. Under the statement of claim, the decoders suffered from three serial hardware faults which were under the defendant's liability and which caused DBS severe damages, mainly due to the need to repair them and to bear the costs involved in such. The claim is for the sum of approximately NIS 31.4 million, and is based on various causes of action including breach of framework agreement by the defendant, negligence against DBS and breach of the provisions of law, DBS retaining its right to sue for additional damages.
- 5.17.2** On December 28, 2006, a claim was filed against DBS in the District Court at Haifa by Al-Jazeera Satellite Network, which produces and edits the Al-Jazeera channel that is broadcast in Arabic (hereinafter: the "channel"), and the programs broadcast on that channel (hereinafter: the "programs"). In its claim, the plaintiff alleges that DBS has for several years been broadcasting the channel without a permit from the plaintiff, and that it is thereby in breach of its copyright and performers' rights in the channel and in the programs, and of the intellectual property relating to such, and that it is causing it various forms of damage. The plaintiff is suing for a monetary sum of NIS 3,000,000 (for fee purposes), that an injunction be issued against DBS prohibiting it from broadcasting or making use of the channel, that DBS give the plaintiff accounts of all use made of the channel and that DBS give the plaintiff any copy that infringes the plaintiff's copyright. The parties are negotiating a settlement.
- 5.17.3** On November 6, 2006, an application was filed with the District Court at Tel Aviv to approve a class action against DBS. The claim and the application stated that DBS had not, as it were, returned the full sums owing to the Applicant and to other subscribers who chose to terminate their contract with it, out of the deposit given by them as security in return for terminal equipment lent to subscribers. The Applicant did not set out the total damage of the members of the group, on the grounds that such data was in the possession of DBS. In her view, the damage caused to her as at the date of filing of the claim is NIS 546.74 and she assesses the cumulative damage of members of the group at more than NIS 16 million.
- 5.17.4** On January 5, 2005, DBS filed a claim in the Local Court at Tel Aviv against a company and two of its subscribers following information that it had received that the broadcasts of channels 5+ and Tchelet, originally produced by it, were being transmitted on the internal cable network of the town of Efrata in Judea, and were being received in all of the homes of that town that were connected to such cable network. Investigations by DBS showed that the channels' transmissions were being received via two decoders which contained DBS smart cards, and that those decoders were decoders that had been given to the defendants. It also became apparent that transmission of the broadcasts of the channels in the town was being done via the broadcast center operated by the defendants in the town. DBS demanded to charge the defendants to pay compensation in the sum of NIS 2,000,000 for filing fee purposes, and in addition, DBS petitioned for a declaratory order to the effect that the Defendants had breached DBS's rights under the Copyright Ordinance. Since liquidation orders and receivership orders were issued against the two defendants in the file, and in light of information regarding the poor financial situation of the remaining defendant in the file, DBS decided to withdraw the claim. On August 9, 2006, DBS filed a debt claim in the sum of NIS 27,200,000 to the Official Receiver for the debt of one of the defendants.
- 5.17.5** On July 6, 2005, DBS filed a statement of claim in the District Court at Tel Aviv, in which it requested that the Court charge the defendant to pay the direct costs which DBS bore in order to repair faulty decoders of a certain model assembled and/or manufactured by the defendant and supplied to DBS between 2000-2001. The claim is in the sum of approximately NIS 31.4 million and is based on various causes of action, including breach of framework agreement with the defendant, negligence to DBS and breach of legal provisions, DBS retaining its rights to sue for additional damage.
- 5.17.6** For other legal proceedings in which DBS is involved, see Notes 15, 17 and 32 to the Company's financial statements for the year ended December 31, 2006, included in this periodic report, and Section 1.1.5(a) above.

5.18 Goals and Business Strategy

- 5.18.1** DBS's goals are to continue the trend of growth of DBS's revenues, by continuing the gradual increase in the number of DBS's subscribers, DBS intending a relatively small increase compared with the rate of increase in 2005 and 2006, and by continuing the growth of its average revenue per user (ARPU).
- 5.18.2** In order to achieve the goal of increasing the number of subscribers, DBS intends to invest considerable efforts in the field of marketing and sales and in appropriate marketing strategies, which are intended for the continued recruitment of subscribers, via DBS's sales system, to continue its efforts to create differentiation and innovation in the content of its broadcasts compared with those of the Cable Company, to continue expanding DBS's added value services, and to continue investing in customer services and in retention of existing customers and to increase revenues from them. These efforts include DBS's striving to obtain a license for VOD services, and for the option to market a bundle of services including television services, internet packages and telephony services either by obtaining a license to supply VOB services or by marketing the telephony services of a third party. In addition, DBS is working on increasing penetration of PVR decoders among its subscribers, so as to increase its revenues and the loyalty of its subscribers to its services.
- 5.18.3** In order to increase ARPU, DBS is working on obtaining a license for VOD services, to market telephony services and to increase the penetration of PVRs as aforesaid, and in addition, is working to increase the scope of content sold to subscribers, by expanding content supply, availability of a variety of services and intensive efforts to sell DBS's products.
- 5.18.4** DBS's goals with respect to increasing the number of subscribers and the ARPU are based on forecasts by management of DBS, based on the current trend in the broadcast market and on DBS's presumptions regarding competition in the field of broadcasts and regulations, which apply and which shall apply to DBS's operations and the restrictions imposed upon DBS and its operations, taking into account the restrictions applying to and that shall apply to Bezeq, which affect DBS. However, DBS management forecasts might not come to fruition due to changes in demand in the broadcast market, due to increased competition in this field and due to regulatory restrictions imposed or which might be imposed on DBS or on its joint ventures with Bezeq (see section 5.6.5 above). Realization of DBS's goals with respect to the launch of VOD and telephony services depend, in addition to the above, on obtaining the statutory and regulatory consents required for such purpose (see section 5.6.5 above), and for VOD services, on DBS's agreement to provide such under conditions that will enable the service to be provided, from DBS's point of view, on the availability of Bezeq's DSL network and on the ability to provide the service at a quality level for the Company's subscribers (see section 5.6.5F above). Increasing the penetration rates of PVRs depends also on the availability of such decoders and the dates of supply of them by the manufacturer.

5.19 Discussion of Risk Factors

The following are the threats, weaknesses and risk factors of DBS (hereinafter: the "Risks") deriving from its general environment, from the industry and from the special nature of its operations. It should be emphasized that the risks set out below are rated according to various levels of reasonableness of occurrence, and the reasonableness of the occurrence of some of them, in DBS's assessment, would be very low. However, each risk has an affect irrespective of the reasonableness of its coming about.

5.19.1 Macro risks

- 5.19.1.1 Financial risks – a substantial part of DBS' expenses and investments are linked to fluctuations in the exchange rate of the US dollar. Therefore, strong fluctuations in the exchange rate will have a substantial effect on the business results of DBS. In addition, loans taken out by DBS from banks, from its shareholders and from institutional entities are partly linked to the consumer price index and therefore sharp rises in inflation might have a substantial affect on DBS's business results; some of the loans taken out by DBS from banks are at variable interest rates and therefore, sharp rises in interest rates might have a substantial affect on the business results of DBS.

- 5.19.1.2 Recession – an economic recession, increase in unemployment rates and a decrease in disposable income might bring about a decrease in the number of DBS' subscribers, a decrease in DBS' revenues and harm to its business results.
- 5.19.1.3 Security situation – a continued unstable security situation in most of Israel, which disrupts the day-to-day lives of residents, might bring about a downturn in DBS's business results.

5.19.2 Sector Risks

- 5.19.2.1 Dependence on licenses – DBS provides multi-channel television broadcasts in accordance with a broadcast license and via other licenses. Breach of the provisions of the licenses are likely to bring about, subject to the conditions set out for such in the licenses, the cancellation amendment or suspension of the licenses and as a result of such, substantial harm to DBS's ability to continue operating in the field, and to imposition of monetary sanctions on DBS.
- 5.19.2.2 Changes in regulation – DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies, and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of consents from the Council and the Ministry of Communications. A very high level of regulatory intervention and changes in regulation have an effect on DBS' operations and could substantially harm its financial results.
- 5.19.2.3 Strong competition – the field of broadcasts is characterized by a very high penetration rate and very strong competition, which requires DBS to constantly and continually be investing in recruiting and retaining customers; and dealing with high transfer rates of customers between DBS and the Cable Company. The offer of a bundle of services containing multi-channel television, internet and telephony, which are not offered in this format by DBS, also increases the ability of the Cable Company to compete. Non-provision of VOD services by DBS when the Cable Company does offer such services to its customers also harms DBS's ability to compete.
- 5.19.2.4 Development of new technology – there is a risk in the development of new technology which will prevail over existing technology and turn the existing technology into old technology, and as a result a need for large monetary investments in order to retain competitive standing or alternatively in the event of development of new technologies that enable entry into the field of multi-channel broadcasts without making heavy financial investments, the entry barriers into the field might be lowered and this will constitute a threat to DBS's competitive status. For IPTV technology see section 5.1.4.2 above.
- 5.19.2.5 Types of payments and supervision of tariffs – DBS's license provides the kinds of payments that the Company is permitted to collect. In addition, the Council has the power not to allow amendments to the price list. These restrictions affect DBS's ability to manage a commercial price policy.
- 5.19.2.6 Piracy – DBS is exposed to attempted "piratic" connection by viewers wishing to receive DBS broadcasts without paying a subscription fee. DBS assesses this phenomenon as being marginal only.
- 5.19.2.7 Exposure to claims regarding broadcast of content that breaches legal provisions – DBS is exposed to claims regarding broadcast of content that breaches legal provisions, including breach of intellectual property rights, damage to privacy, damage to good name, broadcast of prohibited content, etc. Its agreements with content suppliers and program producers usually include an undertaking by the supplier / producer to indemnify DBS in the event of contact that infringes the provisions of the agreement and the law.

5.19.3 Special risks to DBS

- 5.19.3.1 The need to arrange additional sources of financing for DBS – raising of sources of financing based on DBS's business plan for the coming years, is essential for DBS's ability to comply with its business plan and enable it to pay back its bank

credit on time. Failure to pay this back on time constitutes grounds for making the bank credit immediately repayable in accordance with and subject to the provisions and restrictions of the financing agreement. Note that there is a regulatory restriction on raising funds from the shareholders of DBS.

- 5.19.3.2 Need for receiving consents from financing banks for the performance of operations by DBS – the doing of operations and certain proceedings are dependent upon the receipt of the prior consent of the banks. This restriction might hinder DBS's operations.
- 5.19.3.3 Exposure to the provision of immediately repayable bank credit as a result of non-compliance with financing agreements – failure by DBS to comply with the provisions of the financing agreement might, in accordance with and subject to the provisions of the financing agreement, give the banks grounds for making all of the bank credit provided to it immediately repayable and the exercise of the securities provided by DBS and its shareholders to the banks.
- 5.19.3.4 Restrictions that are the result of the ownership structure – restrictions imposed upon Bezeq restrict it from providing sources of finance to the Company and from cooperating for the purpose of offering a communications service bundle. These restrictions substantially affect DBS's commercial situation and its ability to compete – see section 5.6.5G above.
- 5.19.3.5 Failure and damage to satellite – DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space. The duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a failure in one of the satellites, it will be possible to move most of the channels broadcast by DBS via the existing space segments on the other satellite, and perhaps even via additional segments on the satellite that might be made available for DBS's use. The Company has no insurance for loss of revenues caused due to satellite malfunction.
- 5.19.3.6 Dependence on space segment suppliers – DBS depends on HLL and IAI which lease it the space segments. Since both of the satellites are in the same place in space, if one of the suppliers stops leasing space segments to the company, DBS assesses that its business results will not be substantially harmed. The aforesaid is forward-looking information based on the assessments of management of DBS regarding the availability of space segments on the remaining satellite and on exercise of DBS's right for back-up with the supplier. However, failure by the supplier to comply with its undertaking to back up as aforesaid might cause substantial harm to DBS's business results.
- 5.19.3.7 Dependence on software, equipment, content, infrastructure and service suppliers – DBS depends upon Bezeq, which enables the Company to purchase internet packages which constitute a very important component of the package sold to DBS's subscribers. If Bezeq does not supply DBS with the services, DBS's ability to compete will suffer; in addition DBS is dependent upon certain software, equipment, content and service providers and failure to receive the products or services provided by them might harm DBS's ability to function or its rate of growth.
- 5.19.3.8 Dependence on use of internal wiring – DBS depends on the use of internal wiring in subscriber homes, which is owned by the Cable Company, and the use of which is effected in accordance with the administrative order. As set out in section 5.14.3 above, as at the date of the financial statements, the Ministry of Communications is considering cancelling the administrative order. If the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the recruitment of subscribers to DBS.
- 5.19.3.9 Harm to broadcast centers – harm to a broadcast center might cause a significant difficulty for continued broadcasts, however, the splitting of broadcasts into two broadcast centers (Kfar Saba and Reem Junction) significantly reduces the risk involved in harm to one of them and improves the possibility that most of the

broadcasts will survive. As at the date of these reports, DBS broadcasts from both of the broadcast centers at once, some channels being broadcast from one center and DBS's home channels being broadcast only from Kfar Saba, and being stored at the broadcast center at Kfar Saba only. If one of the broadcast centers is damaged, DBS will transmit most of its broadcasts via the second broadcast center, however, as at the date of the reports, in the event of damage to DBS' broadcast center at Kfar Saba, the Company will have only a limited ability to transmit DBS' home channels via the other broadcast center, and DBS is operating to improve the broadcast of home channels from the secondary broadcast center.

- 5.19.3.10 Technical inferiority and the inability to offer combined services – DBS's technology is technically inferior to that of its competitors. This technical inferiority prevents DBS from providing telephony services, internet and various interactive services, including VOD, over its infrastructure, and requires it to purchase these services or to enter into joint venture agreements in order to provide such services to its customers.
- 5.19.3.11 Inability to offer a combined analog and digital package – DBS provides its customers with digital decoders only, whilst the Cable Company can provide both analog and digital decoders. The offer of two kinds of decoders makes the cost of equipment cheaper for subscribers, and improves the Cable Company's ability to compete.
- 5.19.3.12 Defects in the encryption system – DBS's broadcasts are based on the encryption of broadcasts transmitted via satellites and encoded via smart cards that are installed in the decoders in subscribers' homes. Defects in the encryption system or breach of it might enable broadcasts to be viewed without payment being made to DBS, thereby causing a reduction in revenues and a breach of the agreements between DBS and its content suppliers.
- 5.19.3.13 Exposure due to broadcast of channels without an agreement – DBS broadcasts approximately 10 channels to its subscribers which are broadcast from their broadcast origin as unencrypted satellite broadcasts, and which can be received in Israel (even without a decoder) without any agreement with the owners of the broadcast rights. DBS makes an effort to regulate contracts with owners of broadcasting rights and is exposed to claims by the owners of broadcasting rights.
- 5.19.3.14 Exposure to payments of stamp duty - DBS might be required to pay stamp duty on agreements which it signed before stamp duty was repealed. DBS has made an appropriate provision in its financial statements.
- 5.19.3.15 Exposure to class actions – given the large number of subscribers that the Company has, the Company is exposed to class actions and the more subscribers, the greater the exposure to class actions in significant sums. For applications pending against DBS for approval of claims as class actions see section 5.17 above.
- 5.19.3.16 Compliance with conditions and instructions of the Ministry of the Environment regarding the broadcast center – in the event of failure to comply with the conditions and instructions of the Ministry of the Environment with respect to the broadcast center.

5.19.4 The following table sets out the risk factors based on their nature and ranking according to their effect in the opinion of DBS's board of management.

Level of Effect			
Small	Medium	Large	
			<u>Macro risk</u>
	X		Financial risks
X			Security situation
X			Recession
			<u>Industry Risk</u>
	X		Dependence on licenses
		X	Changes in regulation
		X	Strong competition
		X	Development of new technology
X			Tariff control
X			Piracy
X			Exposure to claims for broadcasting infringing content
			<u>Special Risk</u>
		X	Need to arrange additional sources of finance
X			Need for approval for company operations from financing banks
	X		Exposure to bank credit becoming immediately repayable due to non compliance with financing agreements
		X	Restrictions due to structure of ownership
	X		Satellite malfunction
	X		Dependence upon space segment supplier
		X	Dependence on suppliers of content, equipment and infrastructure
	X		Dependence on suppliers of essential content
		X	Damage to broadcast centers
		X	Technical inferiority and inability to offer combined services
X			Inability to offer combined analog and digital packages
		X	Encryption system
X			Exposure regarding broadcast of channels without agreement
X			Stamp duty
	X		Legal proceedings
X			Compliance with environmental restrictions

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Dov Weisglass, Chairman of the Board

Yacov Gelbard, CEO